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INSIGHTS

DEMYSTIFYING KEY COMPLEXITIES OF THE INDIA BUDGET 2024-25

DESIGN AND IMPACT OF THE COLOMBIAN “SIGNIFICANT ECONOMIC PRESENCE” REGIME

BLUNDERS IN INTERNATIONAL ESTATE PLANNING

AND MORE

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About Us

EDITORS' NOTE

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

- **Demystifying Key Complexities of the India Budget 2024-25.** The Indian finance minister presented Budget 2024-25 (the "Budget") earlier this year. During the last financial year, the Indian economy reported growth rate in G.D.P. of 8.2%. Surpassing the United Kingdom, India has sprinted to the position of the fifth largest economy in the world. Budget 2024-25 has been crafted to continue the economic growth of the county. To that end, the budget includes the following provisions regarding direct taxation: (A) Favorable changes in the holding period and tax rates for long-term capital gains, (B) Limitations on the availability to index costs when computing capital gains that in many instances are taxed at lower rates, (C) Parity in rates for residents and nonresidents, (D) Abolition of the Angel Tax, (E) New tax rules for the taxation of a corporate buyback of shares, and (F) The repeal of Equalization Levy 2.0 on e-commerce transactions. Jairaj Purandare, the Founder & Chairman of JMP Advisors Pvt Ltd, Shibani Bakshi, an Associate Director of the firm, and Siddhita Desai, an Associate with the firm, explain the new provisions.

- **Design and Impact of the Colombian "Significant Economic Presence" Regime.** Before and after joining the O.E.C.D. in 2020, Colombia was an enthusiastic adopter of international tax policies promoted by the O.E.C.D.'s B.E.P.S. Project. Two motivations spurred this action. First, the government wished to overcome technical gaps in the domestic legislation of cross-border taxation. Second, the government sought additional revenue from nonresident companies doing business with clients based in Colombia. However, the Significant Economic Presence ("S.E.P.) regime breaks with the tradition of adopting modifications in a way that is consistent with O.E.C.D. policies. Colombia created the S.E.P. regime as a unilateral alternative to the global proposal of Pillar 1, rejecting this proposal based on two strategic considerations. The first was the low probability of global implementation. The second was the expansion of the tax base beyond that provided by Pillar 2. Depending on your viewpoint, the S.E.P. regime contains certain elements that resemble an income tax and other elements that resemble a V.A.T. Eric Thompson, a Partner of attorneys Cañón Thompson in Bogota, takes a deep dive in his article and tells all. He suggests that a tax that was intended to raise revenue from nonresident suppliers may simply result in price increases in Colombia. Who knew that could happen?

- **Blunders in International Estate Planning.** Trust & estate lawyers who dabble infrequently in cross border matters, take notice! It is relatively easy to lose your way when advising a non-U.S. person with assets in the U.S. Shortcuts that work when clients and properties are located in the same jurisdiction may lead to horrific problems when clients are domiciled in one jurisdiction and property is located in another. Examples are (A) drafting two wills where each revokes the other, (B) allowing an individual having a foreign domicile to directly own financial assets in the U.S., such as shares of publicly traded stock or mutual funds, can result in unanticipated estate tax and long delays before heirs have access to the assets, (C) not knowing which

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I.R.S. information reporting forms must be filed when a new client is a recent arrival from abroad can yield significant penalties for the client, (D) allowing a resident, non-citizen individual to return to the home country is an invitation to unnecessary U.S. estate tax if the client retains investment assets and real property in the U.S., and (E) not noticing inconsistencies in residuary clauses in a principal will drafted in the home country and a U.S. property only will drafted in the U.S. begs for a will fight. Diane K. Roskies, a principal in the New York office of the Offit Kurman law firm, and Zachary Weitz, an attorney in the Los Angeles office of the same firm, explain the severe problems that may be encountered, but do so in a light hearted manner.

- **French Life Insurance "101" – For U.S. Persons, Run Away.** An individual takes out life insurance in order to provide for his heirs and to obtain peace of mind. Tax treatment for the individual during life and the heirs is straightforward when everyone resides in one country. But when a life insurance policy is written in France and the insured or the heirs are U.S. citizens or residents, what the policy holder, his estate, or the beneficiaries may encounter is anything but peace of mind. To their chagrin, each may find that he or she is in the crosshairs of contrary laws in two countries resulting in sub-optimal tax results. In their article, Sophie Borenstein, of attorneys Klein Wenner in Paris, Neha Rastogi, and Stanley C. Ruchelman discusses the French and U.S. tax rules applicable to a French life insurance policy. Grown men have cried over less complicated matters.

- **The Aftermath of YA Global: Who is a Partner?** The YA Global case has drawn widespread attention due to the U.S. tax implications for foreign investment partnerships investing in U.S. securities or making use of a U.S. investment manager. The I.R.S. prevailed in the U.S. Tax Court, and the foreign investment partnership was found to have been engaged in the conduct of a U.S. trade or business in the facts presented. The Tax Court has now released a follow-up memorandum opinion that addresses the following question: what standard should be applied when determining whether a foreign recipient of an income payment from a partnership should be recognized as a partner for income tax purposes and subject to Section 1446 withholding tax? At stake is the U.S. withholding tax imposed on partnerships with foreign partners and U.S. effectively connected income. Wooyoung Lee and Stanley C. Ruchelman address the issue. Sometimes, financial engineers develop a plan that works well when stress tested in the office, but is far too complicated for the I.R.S. and Tax Court judges.

- **Democrats vs. Republicans: OPPOSITE VIEWS on Taxes.** One political party promotes higher taxes to fund a better life for voters in underserved places. The other political party promotes freedom to succeed financially from succeeding in business. Which political party will attract the most voters? It is anybody's guess. Nina Krauthamer and Wooyoung Lee review the stated tax policies of the two parties. What is clear is that the supporters of the party that does not succeed will be very unhappy with the tax policy of the victor.

We hope you enjoy this issue.

\- The Editors

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DEMISTIFYING KEY COMPLEXITIES OF THE INDIA BUDGET 2024-25

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INTRODUCTION

The Indian finance minister ("F.M.") presented Budget 2024-25 (the "Budget") on July 23, 2024, This was the current F.M.'s record-breaking seventh consecutive budget and the first budget after the Modi-led N.D.A. 3.0 government was back in power. Subsequently, on August 7, 2024, amendments were made to some of the direct tax proposals announced in the Budget.

BUDGET AT A GLANCE

During financial year ("F.Y.") 2023-24, the Indian economy emerged strong and resilient with a gross domestic product ("G.D.P.") growth rate of 8.2%. Surpassing the United Kingdom, India has sprinted to the position of the fifth largest economy in the world, and is not far from overtaking Japan and Germany to attain the third spot.

Budget 2024-25 continues to focus on four major categories: (i) the poor, (ii) women, (iii) youth, and (iv) farmers. Some of the noteworthy policy proposals announced in the Budget include the following areas of focus:

- Agriculture
- Five schemes for employment and skill upgrading
- The development of road connectivity projects
- Women-led development
- Irrigation and flood mitigation
- The promotion of tourism
- The simplification of foreign direct investment
- Opportunities to use the Indian Rupee for overseas investments

Overall, Budget 2024-25 is testimony to the fact that the Indian economy continues to grow. With a growth rate of over 7% for the third consecutive F.Y., the economy is on track to achieve its goal of "Viksit Bharat," or "Developed India," by 2047, which is the centennial anniversary of India's independence.

KEY AMENDMENTS IN THE DIRECT TAX SPACE

On the tax front, the Budget offered a blend of promising measures and some less favorable elements.

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This article discusses some of the significant direct tax proposals announced in the Budget. The direct tax proposals discussed below are effective for F.Y. 2024-25, *i.e.*, from April 1, 2024, onwards, unless otherwise stated.

Corporate Tax Rate

Generally, Indian domestic tax law provides different base tax rates for domestic and foreign companies. Earlier, domestic companies were taxed at a base rate of 30% and smaller domestic companies with a turnover of up to INR 4 billion (~$50 million) were taxed at a base rate of 25%. In addition, domestic companies were required to pay a dividend distribution tax ("D.D.T.") at a base rate of 15% on profits distributed by way of dividends. The base rate of tax for foreign companies has been 40% since F.Y. 2002-03, with no additional taxes on the distribution of profits.

Both domestic and foreign companies are required to pay a surcharge, as applicable, on top of the base tax, as well as a health and education cess[1] of 4%, which is levied on the aggregate of the base tax and surcharge, if any. The surcharge is an additional tax that must be paid by taxpayers earning a higher level of income, determined based on their legal entity status and in accordance with the income thresholds specified in the tax law. The health and education cess is required to be paid by all taxpayers and is an additional tax collected to specifically fund the government's health and education initiatives.

Domestic as well as foreign companies were also subject to the provisions of the minimum alternate tax ("M.A.T."), which is computed at the base rate of 15% on book profits.

The applicability of the D.D.T. to domestic companies narrowed the gap between the headline tax rates for foreign companies and domestic companies.

In September 2019, a new optional tax regime was introduced for domestic companies. Under this optional regime, the rate of tax for domestic companies was reduced from 30% to 22%, subject to a taxpayer meeting certain conditions. This resulted in a maximum tax rate of 25.17% (including the surcharge and health and education cess) for domestic companies which opted for the new regime. Domestic companies which opted for this regime were also not subject to M.A.T. provisions.

Subsequently, from F.Y. 2020-21 onwards, the D.D.T. was abolished and the taxation of dividend was shifted to the recipients of the dividend.

The reduction in the corporate tax rate for domestic companies along with the elimination of the D.D.T. significantly widened the gap between the base tax rates applicable to foreign companies (40%) and domestic companies (22%). Globally, the general practice is to have a tax rate parity across all kinds of entities within the same industry.

The Indian government has reviewed various proposals to reduce the corporate tax rate applicable to foreign companies and address this disparity. The tax law was amended to lower the base corporate tax rate for foreign companies from 40% to 35% as of April 1, 2024. With this decrease in the base rate, the maximum effective tax rate for foreign companies is reduced from 43.68% to 38.22%. This long-awaited amendment brings considerable relief for foreign companies.

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[1] A cess is a form of charge that is used to fund a specific purpose.

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TAXATION OF CAPITAL GAINS

In General

As per the domestic tax law, income is computed under five headings, one of which is capital gains. Income arises under this heading when a person transfers a capital asset as defined in the tax law.

Capital gains are further categorized as either long-term capital gains ("L.T.C.G.") or short-term capital gains ("S.T.C.G.") based on the holding period of the asset.

The taxation of capital gains in India is quite complex as compared to global markets, and requires the taxpayer to consider various aspects, including

- the type of asset;
- the holding period of the asset;
- differences in the rates of tax for different asset classes, including specific provisions for financial assets (equity and debt);
- differences in the rates of tax based on the residence status of the transferor; and
- the availability of an indexation benefit.

"Capital gains are further categorized as either long-term capital gains or short-term capital gains based on the holding period of the asset."

Further, the capital gains tax regime has undergone various revisions over the past few years. In order to attract foreign investments and create a vibrant Indian economy, simple and predictable tax treatment is of paramount importance.

With a view towards simplifying the capital gains tax regime, various amendments have been introduced in the Budget which will take effect from July 23, 2024. Some of the key amendments are discussed below.

Holding Period of Asset

Firstly, the tax law has been amended to provide for only two holding period rules to determine whether a capital gain is an S.T.C.G. or an L.T.C.G. The holding period for L.T.C.G. treatment is 12 months for listed securities. The term "listed securities" under Indian domestic tax law refers to securities which are listed on a recognized stock exchange in India. For all other assets, the holding period for L.T.C.G. is 24 months. The 24-month holding period applies to unlisted securities and to securities which are listed on foreign stock exchanges.

Base Rates of Tax

L.T.C.G.

Under the earlier tax law, L.T.C.G.'s were taxed at a base rate of either 10% or 20% depending on the asset class. The Budget has amended the base rates of tax on L.T.C.G.'s to create uniformity across all asset classes.

Under the amended provisions, the base rate of tax on an L.T.C.G. has been standardized at 12.5% for all asset classes. On one hand, this provision has resulted in a favorable change for certain assets, such as unlisted shares and real estate, which

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were generally taxed at 20% under prior law. However, for assets such as listed shares and units of equity-oriented mutual funds, the rate of tax was increased from 10% to 12.5%.

S.T.C.G.

Under the existing tax law, the base rate of tax on an S.T.C.G. was either 15% or the relevant tax rate applicable to the respective taxpayer (which could range from 5% to 40%, depending on legal entity status and income level). Now, the base rate of tax on S.T.C.G.'s will be 20% or the relevant tax rate applicable to the taxpayer. This amendment has resulted in an increase in the tax rates applicable to the transfer of certain short-term capital assets, such as equity shares, units of equity-oriented mutual funds, and units of a business trust, from 15% to 20%. Gains arising from the transfer of other short-term capital assets will continue to be taxed at the relevant rates applicable to the respective taxpayer.

Further, under the revised provisions, capital gains from the transfer, redemption, or maturity of certain classes of assets will be taxed as S.T.C.G.'s irrespective of the period of holding. Assets subject to S.T.C.G. treatment include

- unlisted bonds and debentures;
- market-linked debentures; and
- units of specified mutual funds that invest more than 65% in debt and money market instruments.

The rate of tax on these assets will be the relevant tax rate applicable to the taxpayer. For units of specified mutual funds, grandfathering provisions have been introduced for units purchased before April 1, 2023, and these units will continue to be taxed as either an S.T.C.G. or an L.T.C.G. based on the actual holding period.

Indexation of Cost

Under prior domestic tax law, taxpayers were permitted to reduce L.T.C.G. by applying the indexed cost of an asset instead of the original cost for certain assets. Indexation is essentially a mechanism to adjust the purchase price of assets for inflation.

In the initial Budget announcement, the F.M. announced the withdrawal of the indexation provisions. Thereafter, perhaps taking into consideration the backlash from taxpayers, the provisions relating to indexation were grandfathered for certain assets in the amendments to the Finance Bill.

As per the revised provisions, the benefit of indexation is now available only to resident individuals and certain other resident taxpayers ("Hindu Undivided Families") on the transfer of immovable property which was acquired before July 23, 2024. Accordingly, L.T.C.G. tax on the transfer of immovable property acquired before July 23, 2024 will be computed as the lower of either

- 12.5% on L.T.C.G.'s computed without indexation, or
- 20% on L.T.C.G.'s computed with indexation.

No benefit of indexation will be available in any other case.

The removal of the indexation benefit will potentially increase the amount of taxable L.T.C.G.'s for assets purchased after July 23, 2024, especially for real estate, which typically are held for long periods of time. This amendment affects many taxpayers.

Basic Exemption Limit for L.T.C.G.

A small increase has been provided in the basic exemption limit on the taxation of L.T.C.G.'s, from INR 100,000 (~$1,200) to INR 125,000 (~$1,500). Accordingly, L.T.C.G.'s will be taxed only if they exceed INR 125,000 (~$1,500) in an F.Y. This exemption is applicable only to L.T.C.G.'s arising from the transfer of certain assets such as equity shares, units of equity-oriented mutual funds, and units of a business trust, which have been subject to payment of securities transaction tax ("S.T.T.")

Parity Between Residents and Nonresidents

In order to bring parity between the taxation of residents and nonresidents, there will be no difference in the rates of tax paid by residents and nonresidents on capital gains. With this amendment, the tax rate on L.T.C.G.'s arising on the transfer of certain classes of assets has been increased from 10% to 12.5%. Assets affected by this rule include:

- Units acquired by an offshore fund in a foreign currency, and
- Bonds of an Indian company or global depository receipts acquired by a non-resident in a foreign currency.

This revision may influence investment and tax planning strategies.

Overall Comment

It may be observed that sweeping amendments have been made to the capital gains tax regime in the Budget. While some of the above amendments, such as a uniform holding period, help in simplifying the capital gains tax regime, the result of certain other amendments may actually be an additional tax burden, such as the withdrawal of the indexation benefit in most cases, or the increase in base tax rates for certain assets. Therefore, there are mixed reactions among taxpayers to these amendments.

ABOLITION OF ANGEL TAX

Over the past few years, India has experienced an unprecedented surge in the creation and funding of start-up companies. However, the growth of the start-up ecosystem was somewhat hampered by the introduction of the "angel tax," starting from F.Y. 2012-13. This was part of various measures introduced to curb the generation and circulation of unaccounted money.

The term "angel tax" refers to the income tax levied on funds raised by unlisted domestic companies in excess of the fair market value ("F.M.V.") of equity shares issued by such companies. This tax generally impacts angel investment in start-ups. For that reason, it is popularly referred to as the "angel tax." The angel tax is required to be paid by unlisted domestic companies. Venture capital undertakings were kept outside the purview of the angel tax. Complex valuation rules were introduced for the determination of the F.M.V. of shares of such companies.

The angel tax provisions were relaxed slightly in F.Y. 2018-19, to reduce the burden on smaller start-ups. Start-ups having an aggregate share capital and share premium up to INR 100 million (~$1.2 million) were outside the purview of the provisions of the angel tax. The relaxation was effective from April 11, 2018. This limit was further raised to INR 250 million (~$3 million) as of February 19, 2019. However, due to the low exemption threshold, a majority of businesses remained subject to angel taxation.

Initially, the scope of the angel tax was restricted to funds raised by unlisted companies from Indian residents. However, the scope of the angel tax was expanded to cover funds raised from nonresidents, effective from F.Y. 2023-24.

In nascent stages when start-up companies have their greatest need fort funds to build their businesses, start-up companies generally do not have significant value. Consequently, most start-up businesses would fall within the scope of the angel tax. Hence, over the years, angel taxation has continued to be a hindrance to the fundraising capacity of start-ups.

"To boost the start-up ecosystem further and to encourage innovation, the Budget abolishes the angel tax across all classes of investors."

To boost the start-up ecosystem further and to encourage innovation, the Budget abolishes the angel tax across all classes of investors. This amendment is effective for F.Y. 2024-25 onwards. The elimination of the angel tax is viewed as a significant reform that will simplify the funding process for start-ups in India and in turn boost job creation.

TAXATION OF BUYBACK OF SHARES

A buyback of shares or a share repurchase scheme is a corporate action under which a company buys back its own shares from existing shareholders. A buyback is usually undertaken to maintain a majority stake or to distribute surplus cash available within the company.

In general, a company that has distributable profits has two options in order to distribute them to its shareholders: a *pro rata* buyback of shares or a distribution of dividends. Earlier, both modes of distribution were subject to tax in the hands of the company. However, in the past few years, the tax law has been amended to subject the shareholders to tax in both cases.

Prior Law

Prior to its repeal, companies distributing dividends were required to pay a D.D.T. at 15% on the amount of the dividends. The dividends were exempt in the hands of the shareholders. Subsequently, the tax law was amended to abolish the D.D.T. with effect from F.Y. 2020-21. Hence, dividends are now taxed in the hands of the shareholders at their respective tax rates.

On the other hand, net buyback proceeds were taxable in the hands of the shareholders in the form of capital gains at lower tax rates. Since there was no D.D.T. under this mode of distribution, the buyback of shares was a favored mode for distribution of profits by companies.

In order to bring parity to the taxation of the distribution of profits, the tax law was amended with effect from June 1, 2013, to introduce a tax on the buyback proceeds paid to shareholders. Companies were required to pay tax at a flat rate of 20% plus

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the applicable surcharge and health and education cess on such buyback proceeds. Consequently, the income arising from the buyback was exempt in the hands of the shareholders.

Budget Amendment

The Budget has now amended the tax law to align the taxation of buyback proceeds with the dividend regime. Effective October 1, 2024, the flat tax rate of 20% on buyback proceeds has been eliminated, and buyback proceeds are now treated akin to "deemed dividend income" in the shareholders' hands. No deduction for expenses will be allowed against this deemed dividend and hence, the gross receipts will be subject to taxation at the respective tax rates applicable to the recipient. The domestic company is required to withhold tax at applicable rates on the amount paid to shareholders on the buyback of shares.

Further, under the amended provisions, when a company undertakes a buyback, it will result in the transfer of a capital asset for the shareholder. For the purposes of computing the capital gains on such a transfer, the value of consideration received by the shareholders on a buyback of shares will be deemed to be nil, resulting in a capital loss for the shareholders equivalent to the cost of the shares.

Shareholders will be eligible to set off the above loss against other eligible capital gains earned, in accordance with the provisions of the tax law. This new provision may be less tax efficient for many shareholders. For instance, a shareholder may pay tax on buyback proceeds at the applicable tax rates which could go up to 30% for residents, depending on legal entity status and income level, and 20% for nonresidents, including foreign companies subject to tax treaty benefits. However, if this is a long-term asset for the taxpayer, the capital loss on buyback will be permitted to be set off only against L.T.C.G.'s which would have been otherwise taxed at a rate of 12.5%.

The intention of this amendment appears to be to ensure that both methods of distribution of accumulated reserves are taxed similarly. However, frequent amendments in the taxation of buybacks and dividends over the past few years have not gone down well with taxpayers, leading to a sense of uncertainty.

EQUALIZATION LEVY

With the advent of the digital economy in the last decade or so, new business models have given rise to fresh tax challenges globally. The Organization for Economic Co-operation and Development ("O.E.C.D.") issued Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan 1 to address the tax challenges of the digital economy, and set up various task forces to help resolve this issue.

One of the recommendations of the O.E.C.D. was the introduction of the "equalization levy." This levy was intended to tax the significant economic presence of a nonresident enterprise in another country.

India introduced an equalization levy ("E.L.") of 6% on certain online advertising and related services effective from F.Y. 2015-16. Subsequently, India expanded the scope of the equalization levy to include the e-commerce supply of certain goods

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or services by a nonresident e-commerce operator. An E.L. of 2% ("E.L. 2.0") was introduced on consideration received or receivable by e-commerce operators from the e-commerce supply of goods or services. The expansion took effect from F.Y. 2020-21.

E.L. 2.0 is payable by an e-commerce operator who does not have a permanent establishment in India if its turnover from e-commerce operations during the relevant F.Y. exceeds INR 20 million (~$240,000).

Income of nonresidents which has been subject to E.L. and E.L. 2.0 is exempt from other provisions of domestic income tax of India. However, since E.L. as well as E.L. 2.0 were not introduced in the domestic tax law but under a separate Finance Act, taxpayers face a challenge in claiming a foreign tax credit for these levies in accordance with the provisions of double taxation avoidance agreements, causing undue hardship to nonresident taxpayers.

Due to the broad definitions of the terms "e-commerce operator" and "e-commerce supply or services," and a low monetary threshold for applicability of the E.L., many business transactions were covered under the scope of the levy.

In order to address the above issues, E.L. 2.0, *i.e.*, the 2% levy on e-commerce transactions, has been withdrawn with effect from August 1, 2024. However, the E.L. of 6% on specified online advertising services will continue to apply.

The withdrawal of E.L. 2.0 is indicative of the Indian government's intention to ease compliance requirements, encourage the expansion of digital commerce, and guarantee fair tax treatment across various transaction channels. The withdrawal of E.L. 2.0 is expected to provide a major relief to global e-commerce operators.

ANTICIPATED DEVELOPMENTS

Based on the current global developments and the move towards a global minimum tax, the Budget was expected to lay down the roadmap for the implementation of Pillar Two provisions. Contrary to expectations, the Budget is silent on this issue. Equally, the absence of tax reforms for the electric vehicles sector is notable.

In addition, it was expected that the time limit for the concessional tax regime of 15% allowed to certain new manufacturing companies would be extended with a view to spur employment generation. However, the Budget did not address this provision.

The F.M. has announced in her Budget speech that a comprehensive review and complete overhaul of the income tax law will be undertaken within a period of six months. Accordingly, we may see more simplification and rationalization of the tax law in the next Budget, which will be announced in February 2025.

DESIGN AND IMPACT OF THE COLOMBIAN "SIGNIFICANT ECONOMIC PRESENCE" REGIME

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INTRODUCTION

Before and after joining the O.E.C.D. in 2020, Colombia was an enthusiastic adopter of international tax policies promoted by the O.E.C.D.'s B.E.P.S. Project. Two motivations spurred this action. First, the government wished to overcome technical gaps in the domestic legislation of cross-border taxation. Second, the government sought additional revenue from nonresident companies doing business with clients based in Colombia. This process began with the adoption of the inclusion of the permanent establishment and place of effective management regimes, the controlled foreign entities regime, and the imposition of V.A.T. on services provided from abroad.

However, the Significant Economic Presence ("S.E.P.) regime breaks with the tradition of adopting modifications in a way that is consistent with O.E.C.D. policies. It deviates from fiscal policy recommended by the O.E.C.D. by expanding the scope of domestic source income in order to tax suppliers of goods and services from abroad even when the suppliers maintain no permanent establishment in the country. Thus, Colombia has reacted unilaterally to impose tax on foreign suppliers of goods and services.

Colombia created the S.E.P. regime as a unilateral alternative to the global proposal of Pillar 1, rejecting this proposal based on two strategic considerations. The first was the low probability of global implementation. The second was the expansion of the tax base beyond that provided by Pillar 2.

Both reflect the policies of the Minister of Finance, Dr. José Antonio Ocampo, who developed a significant international reputation for fiscal activism for developing countries. Under his auspices, Colombia took a significant leadership role in the *Regional Platform for Tax Cooperation for Latin America and the Caribbean* that has as one of its main objectives the redistribution of tax powers of member states. His economic policies are reflected in the adoption of the S.E.P. regime.

THE S.E.P. AND INCOME TAX SYSTEM

At the international level, the proliferation of digital services tax ("D.S.T.") regimes in developing countries reflects the rejection of a bilateral approach to income taxation in favor of unilateral approach to expand the tax base. In the case of Colombia, the S.E.P. regime is clearly located in the area of income taxation. It simply expands the concept of national source, while adopting specific taxable elements of tax base and rates.

The purpose of the S.E.P. regime is to tax services that were not previously taxed by applicable legislation. Thus, for example, management and administration services

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provided from outside Colombia that already is subject to withholding tax of 33% is not covered by the S.E.P. regime. In the end, S.E.P. is a special form of national income tax that focuses solely on revenue generated from Colombian sources. It does not expand the concept of a permanent establishment. Had it done so, the S.E.P. theoretically could have allowed Colombia to tax the worldwide income like the country did with permanent establishments of foreign companies in 2019.

PROTECTION OF DOUBLE TAXATION TREATIES

In harmony with the recognition of S.E.P. as an income tax regime, the legislation includes an explicit reference to income tax treaties, confirming their priority in cases of S.E.P. This means that in those cases where a provider of taxable services under the S.E.P. regime is a resident of a country having an income tax treaty in effect with Colombia, the S.E.P. regime will not be applied by Colombia. This is due to the typical prevalence of Article 7 (Business Profits) focused on corporate profits, whereby only the country of residence would have the power to tax income not expressly covered under other articles of the income tax treaty.

This clear prevalence of the income tax treaty over the S.E.P. is not only valuable for the effect of digital services, but even more so for goods. As a result, business groups that are likely to come within the S.E.P. tax regime may restructure their internal supply chain so that sales to customers in Colombia will be made by subsidiaries located in an income tax treaty jurisdiction.

COVERAGE OF DIGITAL SERVICES OR SERVICES SOLD IN THE DIGITAL MARKETPLACE

The legislative process of the tax reform bill that included the S.E.P. regime left open the debate on whether the S.E.P. regime covered only digital services and services sold through a digital market or was intended to cover any services performed abroad for the benefit of a Colombian resident. The latter expansive reading would suggest that the S.E.P. is akin to a V.A.T. applied to services performed abroad by nonresidents.

This uncertainty was not resolved by the draft Regulatory Decree that was circulated in November 2023 or its final version. It was the Colombian Tax Administration, commonly referred as the "D.I.A.N.," that concluded the S.E.P. regime taxes only digital services or those services sold through a digital market. The conclusion of the D.I.A.N. is well supported by the analysis of the legislative evolution of this particular reform. So long as it does not change, any service that is not digital and not sold through a digital market is excluded from the S.E.P.

COVERAGE TO GOODS IN GENERAL

When Colombia adopted a D.S.T., it covered the generic category of "goods" without any conceptual restrictions or clarifying guidelines. As a result, goods include both tangible and intangible assets. The D.I.A.N. has simply confirmed its understanding that there is a generic coverage of goods in the S.E.P. regime. Consequently, Colombia adopted an expansive deviation from the international standard of not imposing income tax on the import of goods.

The sensitivity to a possible payment of income tax to the exporter of goods from another jurisdiction cannot be underestimated. Income tax is imposed at the rate of 3% on gross sales to Colombian customers if the supplier files a tax return or at a 10% withholding rate, which is both a final tax. With different source of income rules applied in Colombia and abroad, double taxation would exist, distorting Colombia's competitive position from the perspective of a supply chain.

The alternative to mitigate such inefficiency would be a gross-up of the sales price so that the seller achieves the same amount of after-tax profit.[1] It follows that this would generate an inefficient increase in cost structure for the Colombian importer. Ironically, this if this ultimately shifts the economic cost of the tax to the Colombian importer, contrary to the intent of the government.

In the case of suppliers from the U.S., where there is no S.E.P. antidote in the form of an applicable income tax treaty with Colombia, a Free Trade Agreement exists that restricts tariffs and nontariff measures that affect trade. Already, statements have been made by American trade associations about the potential violation of the Agreement resulting from the enactment of the S.E.P. regime. To the extent that the door to goods is kept completely open and the criteria on "deliberate and systematic interaction" – the threshold that must be reached in order for the S.E.P. regime to apply – remain very vague, the impact of the S.E.P. implies a risk of litigation with countries that fit the situation of the U.S.

In the circumstances, we believe that the Colombian Treasury and the D.I.A.N. have room to limit the coverage of S.E.P. on a discretionary basis so that it applies only to goods sold through a digital market, consistent with the interpretation regarding services. It would help the Colombian economy if this fine tuning is considered sooner rather than later in order to avoid inconvenient distortions in the structuring of businesses, international supply chains and Colombia's competitive position.

THE DEFINITION OF "SIGNIFICANT ECONOMIC PRESENCE"

The S.E.P. regime sought to extend the borderline of income taxation for those companies that sell digital services and/or goods to Colombian clients from a base that is located abroad without triggering a permanent establishment in Colombia. The configuration of the S.E.P. implies something innovative. It is therefore worth asking whether the legislation enacting the S.E.P. regime is clear and predictable.

Under the final legislation, taxpayers targeted by the S.E.P. regime are nonresident persons and nondomiciled entities. The latter covers companies, trusts, and private foundations established abroad. The legislation generically mentions the commercialization of goods or services without any qualification or restriction on the type of goods or services that are covered. Consequently, the term "services" was not restricted to "digital services." The legislation goes on to establish the rates of tax under the S.E.P. regime. Rates are provided for goods and digital services. No rate is provided for physical services. According to the D.I.A.N., this confirms that physical services are outside the scope of the S.E.P. regime.

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[1] A gross-up of prices is discussed in greater detail in the last portion of this article.

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Two combined features trigger the S.E.P. taxable event. The first is the notion of "deliberate and systematic interaction" with clients or users in Colombia. The second is gross revenues in relation to clients or users based in Colombia in the current year or in the previous year of 31,300 tax value units. In 2024, that represents approximately US$ 355,000. If either trigger is not met, the S.E.P. regime would not apply to the foreign supplier. Regarding the gross income metric, it is worth asking whether, as of January 1, 2024, certain foreign companies were already taxpayers via the S.E.P. regime, having exceeded the respective threshold during the 2023 fiscal period.

The trigger based on deliberate and systematic interaction contains no conceptual description of the type of interaction that would trigger a significant economic presence. Conceptually, it should be something less than a permanent establishment. But it should be enough to differentiate it from those services that are materially executed from abroad or from goods produced in another country that would not normally generate income from Colombian sources. In any event, every foreign provider of services or goods interacts with clients or users. No standard is provided to differentiate "deliberate and systematic" interactions from interactions that are less than deliberate and systematic.

There are, however, two explicit presumptions that may be used to determine whether a foreign supplier has interactions that are deliberate and systematic. The first presumption is the following:

> The non-resident person or entity not domiciled in the country maintains an interaction or marketing deployment with three hundred thousand (300,000) or more clients and/or users located in the Colombian territory during the previous taxable year or the current taxable year * * * .

This may mean that the interaction is a marketing display, without specifying that it must be through digital media, typically a website or social network. In this context, advertisements in newspapers or magazines, billboards, or advertisements in movie theaters might be viewed to be marketing displays. Accepting that the principal target is digital marketing, it appears that marketing on social networks such as X, Instagram, or Facebook converts the performance of extraterritorial services or the extraterritorial sale goods physically located abroad into territorial services and sales in Colombia.

This validity of the presumption is open to question because the method by which the threshold is achieved is not clear. It requires that the marketing display with target clients or users be maintained throughout at least one of the years in the two-year measuring period. Arguably, reaching 300,000 contacts on certain days of the year but not on all days or many days may not be sufficient. The above leads to compliance and oversight challenges because no guidance is provided as to how an exact measurement of the clients or users contacted by the marketing deployment will be executed.

The second presumption is very specific and easily verifiable.

> The non-resident person or entity not domiciled in the country maintains or establishes the possibility of viewing prices in Colombian Pesos (COP) or allowing payment in Colombian Pesos (COP).

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Typically, website or social media posts aimed at Colombian residents will include prices denominated in Colombian Pesos, or will provide access to a Colombian Pesos conversion tool, or will allow payment in Colombian Pesos. This would cause a foreign supply to meet the presumption.

In this context, substantive legal questions remain that are not easily answered:

- If neither of the two presumptions are met, is the foreign company removed from coverage by the S.E.P. regime?
- How can the risk of coverage by the S.E.P. regime be ruled out when there is no conceptual definition of activity constituting deliberate and systematic interaction?
- Can the D.I.A.N. apply the S.E.P. regime to a Colombian client company that did not apply the 10% withholding tax by arguing that deliberate and systematic interaction occurred even if one of the two presumptions was not met?

"In sum, when advising a foreign supplier to confirm or rule out the application of the S.E.P., uncertainty as to the scope of the law should be emphasized."

In sum, when advising a foreign supplier to confirm or rule out the application of the S.E.P., uncertainty as to the scope of the law should be emphasized. For a Colombian company making payment to a foreign supplier, the situation is much simpler when the foreign supplier confirms having activated the S.E.P. regime and registers as an income tax payer in the tax registration system.

THE RATE DESIGN OF THE S.E.P. REGIME

The income tax system in Colombia for nonresidents, aligned with the dominant practice of Colombian income tax treaties, provides for the collection of withholding tax on gross income derived from Colombian sources. But in the case of permanent establishments of foreign companies, the system allows for the taxation of net profits by tax return through a special method of calculating the attributable profits.

The S.E.P. regime covers income not covered by this system, which means that there will be an additional dimension of income from national sources. Recall that the law allows nonresident to pay a 10% withholding rate on gross income or an income tax declaration of 3% on gross income. However, under the S.E.P. regime, the alternative calculation of profits is not allowed as the tax base is gross income. This restriction explains the selection of the relatively low rate of 3%, but this impossibility of deducting costs or expenses raises a constitutional concern, given that there are no precedents for an income tax return with this limited structure.

The Treasury encourages nonresident companies to establish subsidiaries or branches in Colombia in order to access a profits taxable base, an argument that would also be applicable to the application of fixed percentages of withholding on gross income. However, there would be a counterargument that the simplicity of the definitive withholdings is a legitimate option that at least is applied equitably. In contrast, the S.E.P. regime represents special treatment between those nonresidents that declare income tax subject to a 35% tax on profits, while nonresidents under the S.E.P. would pay 3% on strict gross income. To the extent that the cost and expense structure is heavier, and the profit margin is narrowed, the 3% might actually generate a higher effective tax rate than the other nonresidents that use the 35% nominal rate, without a clear tax policy justification.

Even accepting for the sake of argument that nonresidents could have different tax rules in relation to residents, the possible asymmetry generated by the option of declaring tax under the S.E.P. regime could fuel an intense debate before the Constitutional Court.

For now, it is likely that the majority of foreign companies will opt for the Income Tax return instead of the withholdings, unless the alternative of the 10% withholding can be better mitigated through the "gross up" mechanism that we explore below.

THE "GROSS UP" ALSO EXISTS

Use of a gross-up clause in contract negotiations is not an uncommon practice when a foreign supplier bills a domestic client. Certainly, this is prevalent in cross-border lending transactions and different types of services. Under a typical gross-up provision the price charged by the supplier is increased, so that after withholding tax is collected, the supplier is able to receive its target price, net of all taxes. In the context of the S.E.P. regime, where 10% withholding is applied, it cannot be ignored that the contractual position of the foreign supplier will be to demand a gross-up of the transaction price to arrive at a targeted after-tax amount. The formula used is straightforward, as follows:

The target price sought by the supplier ÷ (1 – the total tax rate)

In this manner, the Colombian tax cost is transferred to the Colombian customer. If the gross-up formula is part of the sales order, the traditional interpretation of the D.I.A.N. is that the amount of the gross up does not constitute a deductible expense for the customer. Ultimately, the tax is an expense of nonresident. The position of the D.I.A.N. likely is not enforceable where the gross-up computation is embedded in a simple price that is charged to Colombian resident customers without the application of the explicit gross up clause.

FINAL THOUGHTS

The S.E.P. regime likely was thought to be an easy way to tax digital companies based in other countries notwithstanding the difficulty of adopting Pillar One. However, it is not clear that the revenue target will be met. Even if met, use of embedded grossed-up prices may result in an effective tax increase for consumers in Colombia. This paradox should lead to the tax policy argument that any expansion of domestic source income should have the option of applying the income tax on a profits taxable base, which might mitigate the gross-up distortion.

BLUNDERS IN INTERNATIONAL ESTATE PLANNING

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Tags
Foreign Trusts and Estates
Form 3520
Form 3520-A
Penalties
U.S. Federal Estate Tax
Wills (U.S. and Foreign)

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BACKGROUND

This article explores the rarified world of U.S. estate planning for non-U.S. persons owning property in the U.S., uncovering potential pitfalls, and providing insights to navigate the complexities. Five main topics are addressed:

- The risk of two wills inadvertently revoking each other
- The importance of holding cash in the right type of accounts
- Forgetting to file international tax forms
- The complications of leaving assets in the U.S. after moving abroad
- Ensuring a will's cover matches its content

BLUNDER #1: TWO WILLS THAT REVOKE EACH OTHER

U.S. individuals may acquire vacation homes and other assets in Europe. In turn, European individuals may acquire vacations homes in the U.S. Florida has become a popular winter destination for Europeans. Also, Europeans often may have opportunities to work for a few years in the U.S. and acquire homes and investment accounts in the U.S. In each of those fact patterns, estate planning will require international considerations. The simplest plan that comes to mind would be one Los Angeles office person having two wills, one will for the assets in each country. Care must be taken any time a person has two wills.

A will drafted in the U.S. may not be enforceable in another country, and some clients may own property in multiple jurisdictions. The gold standard for international estate planning involves offshore trusts and companies. However, these structures come with hefty costs for drafting and ongoing maintenance. Annual trustee fees and corporate registration expenses are not insignificant and increase with time as the scope of legally mandated responsibilities expands. Many international clients seek to avoid these costs, especially if their estates will not be subject to substantial U.S. estate taxes.

An affordable alternative involves executing two wills, each specifying the specific property covered.

The Case For Having Two Wills

While some attorneys are hesitant about using two wills, when precisely drafted and approved separately by attorneys in both jurisdictions, use of two wills offer a

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concise method for bequeathing property in multiple locations. This approach simplifies probate for a U.S. will that is limited to specific property, in contrast to the complexity of obtaining ancillary probate in the U.S. of a foreign will that covers worldwide assets.

Potential Blunder

One red flag to note is the revocation clause of each will. Normally, a will opens with a revocation statement as follows:

> I, JANE DOE, of the City, County and State of New York, publish and declare this to be my Last Will and Testament and revoke all former Wills and Codicils.

If there are two wills, does the will signed second revoke the first will signed. To prevent this, revocation clauses in both wills are crucial and must be carefully coordinated.

Proposed Revocation Clause

A clause that clearly delineates the scope of each will's bequests and safeguards against unintended revocation is essential. I suggest the following clause:

> I, ANTONIO GONZALES, being a citizen of the United States of America and a resident of the City, County and State of New York, publish and declare this to be my United States Last Will and Testament, to control the disposition of the property hereinafter described and defined as my Estate, and I hereby revoke all Wills and codicils at any time heretofore made by me with respect to such Estate. This United States Will shall not revoke or otherwise interfere with the disposition of any property which is situated in the Republic of Freedonia.[1] This United States Will can only be revoked by another Will, which is later in date than this United States Will. This United States Will may not be revoked unless the revocation clause of another Will specifically refers to this United States Will by date of execution and explicitly revokes this United States Will.

The will continues with a clause that defines "the Estate" that is bequeathed under New York will. In this case, it would be the individual's worldwide assets other than property that is located in Freedonia. A complementary will clause would appear in the will that is drafted to bequeath solely property that is located in Freedonia.

Conclusion

The goal is to safeguard the estate and ensure that the U.S. will does not inadvertently revoke the foreign will or vice versa, safeguarding the intended distribution of assets across jurisdictions. With precise drafting and thorough review by attorneys in the respective jurisdictions, two wills can effectively distribute property situated in different countries.

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[1] In the 1933 film "Duck Soup," Groucho Marx portrays the newly installed president of the fictional country of Freedonia. Throughout this article, Freedonia is the foreign country to which a decedent has a significant contact.

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BLUNDER #2: OVERLOOKING THE ROLE OF CASH IS KING

There are numerous proverbs and sayings regarding money:

- You can't take it with you.
- Money makes the world go round.
- Throwing good money after bad.
- Money talks.
- Time is money.
- A penny for your thoughts.
- A fool and his money are soon parted.
- Money does not grow on trees.
- Cash is King.

In the realm of international estate planning, the last proverb takes precedence.

Understanding the U.S. Federal Estate Tax

In the U.S., a Federal estate tax exist that is imposed on the estate of the decedent. The top rate of estate tax is 40%. Fortunately for U.S. citizens and noncitizens who are domiciled in the U.S., there is a generous exclusion from the estate tax. For 2024, the exclusion is $13.61 million for an individual and $27.22 million for a married couple jointly. By contrast, for an individual who is neither a U.S. resident nor a U.S. citizen (sometimes referred to as an "N.R.N.C. individual") who owns property in the U.S., the estate tax exclusion is only $60,000. When two N.R.N.C. individuals are married, each is entitled to a separate $60,000 exclusion. An estate tax treaty between the United States and a client's home country may expand that $60,000 exclusion so that it matches an exclusion for U.S. citizens and U.S. residents for estate tax purposes.

Additional Estate Tax Exclusions for N.R.N.C. Individuals

A few additional exclusions exist from the Federal estate tax for N.R.N.C. individuals. For example, the death benefit from a life insurance policy that insures the life of a N.R.N.C. individual is not subject to the federal estate tax.

However, the most commonly used exclusion for N.R.N.C. individuals is cash on deposit with a U.S. bank. The cash that an N.R.N.C. individual leaves in a checking account, savings account, or certificate of deposit with a U.S. bank is exempt from the Federal estate tax.

The Blunder

Cash that an N.R.N.C individual leaves in a mutual fund, money market fund, or brokerage account held with a U.S. financial institution is not exempt from the Federal estate tax. Any sum of cash in a mutual fund, money market fund, or brokerage

account will be added to other items of U.S. situs property that is subject to Federal estate tax in the U.S. to the extent total assets exceed the $60,000 exemption.

Knowledge is power, especially when it comes to preserving your wealth across borders.

BLUNDER #3: FORGETTING TO FILE INTERNATIONAL FORMS

“. . . while penalties for domestic tax returns can be potentially substantial, most of the time, the penalties are nominal amounts.”

There are many penalties imposed by the Internal Revenue Service (“I.R.S.”). For example, the penalty for failing to file a tax return is 5% of the unpaid tax per month. The penalty for a failure to file an informational return for which no tax is paid, such as the failure by an employer to issue a W-2, typically is a fixed dollar amount, which ranges between $60.00 to $630.00 for each form not filed. As one can see, while penalties for domestic tax returns can be potentially substantial, most of the time, the penalties are nominal amounts.

However, the penalties for failure to file international informational returns are far more burdensome than the penalties for domestic informational returns. Foreign forms include

- Form 8938 (Statement of Specified Foreign Financial Assets);
- Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts);
- Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner);
- FinCEN Form 114 (Report of Foreign Bank and Financial Accounts (F.B.A.R.));
- Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) – in particular, the penalty for failure to file a Form 3520 is likely the most significant of any penalty issued by the I.R.S. other than those related to tax fraud; and
- Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships).

Understanding the 3520 and 3520-A

There are four instances in which a U.S. person is required to file a Form 3520:

- A U.S. person transfers money or property to a foreign trust.
- A U.S. person is treated as an owner of a foreign trust under Code §§671-679.
- A U.S. person receives a distribution from a foreign trust or used property of a foreign trust without providing sufficient compensation.
- A U.S. person receives a gift or bequest from a foreign person.

The penalties for failing to file Form 3520 depend on the event that triggered the filing requirement and are as follows:

- If the reportable transaction is a transfer of money or property to a foreign trust, the penalty is 35% of the gross value of the property transferred to a foreign trust.

- If the reportable transaction is the treatment of a U.S. person as an owner of a foreign trust, the penalty is 5% of the gross value of the portion of the foreign trust's assets treated as being owned by a U.S. person.

- If the reportable transaction is the receipt of a distribution or the use of property of a foreign trust without providing sufficient compensation, the penalty is 35% of the gross value of the distribution received from a foreign trust.

- If the reportable transaction is the receipt of a gift or bequest from a foreign person, the penalty is 5% of the amount of the foreign gift with a maximum penalty of 25%.

The Blunder

First, let's give an example of the 25% penalty for failure to report the receipt of a gift or bequest from a foreign person. Let's say that, in 2016, a U.S. person received $5.0 million as a gift from a close relative who is not a citizen and who lives in Freedonia and has never resided in the U.S. The U.S. person did not know of the requirement to file Form 3520 to report the gift. Fast forward to the present day when Form 3520 is filed late upon the advice of a tax return preparer. The I.R.S. will automatically issue a notice for penalty and interest related to the failure to file a Form 3520 to report a gift from a foreign person. The penalty is $1.25 million, to which seven years' worth of interest will be added.

Next is an example of the 35% penalty for failure to report the transfer of property to a foreign trust. Let's say that, in 2016, a U.S. person transferred $5.0 million to a trust established under the laws of Freedonia. Again, the U.S. person did not know of the requirement to file Form 3520 to report the transfer to and the interest in the foreign trust. Fast forward to the present day when Form 3520 is filed late upon the advice of a tax return preparer. The I.R.S. will automatically issue a notice for penalty and interest related to the failure to file a Form 3520 to report the transfer of property to a foreign trust. The penalty is $1.75 million, to which seven years' worth of interest will be added.

Avoiding the Blunder

It is hard to fathom the size of these penalties. The easiest way to avoid the blunder is to remember the four instances in which a Form 3520 must be filed. Even if the error is that of the tax return preparer who failed to ask the relevant questions the I.R.S. may not view the error of the C.P.A. as an exoneration of the taxpayer. A taxpayer is required to carefully choose a tax return preparer or adviser based on that person's knowledge and expertise as to reporting obligations for international transactions. In other words, not all tax return preparers are created equal.

Streamlined Domestic and Offshore Procedures

U.S. taxpayers residing in the U.S. facing huge international tax form penalties may be eligible to enter into the Streamlined Domestic Offshore Procedures. If the taxpayer is eligible, rather than the 25% or 35% penalty outlined above, the penalty for the Streamlined Procedures is 5% of the highest aggregate balance/value of the

taxpayer's foreign financial assets that are subject to the miscellaneous offshore penalty related to the F.B.A.R. filing obligation.

In order to be eligible for the Streamlined Domestic Offshore Procedures, the taxpayer must meet the following four requirements:

- The taxpayer is not be eligible for the Streamlined Offshore Procedures discussed below.
- The taxpayer filed a U.S. tax return for each of the most recent three years for which the U.S. tax return due date has passed.
- The taxpayer failed to report gross income from a foreign financial asset, failed to pay tax as required by U.S. law, and may have failed to file one or more international information returns with respect to the foreign financial asset.
- The compliance failure of the taxpayer resulted from nonwillful conduct.

If the U.S. taxpayer resided outside the U.S., the Streamlined Foreign Offshore Procedures may be applicable. Under those Procedures, no penalty is imposed. In order for a U.S. taxpayer to be viewed as residing outside the U.S., the taxpayer must meet two tests in at least one year of the three-year period:

- The taxpayer did not have a U.S. abode.
- The taxpayer was physically outside the United States for at least 330 full days.

Conclusion: Consult a Competent Attorney or Accountant

If a U.S. person who receives gifts from a foreign person, has interests in a foreign business entity, has an interest in a foreign trust, or owns or has signatory authority over one or more foreign bank accounts, an adviser with international tax experience should be retained to review U.S. tax compliance obligations. The I.R.S. has no sympathy and a noncompliant taxpayer may be embroiled in the equivalent of a high-stakes poker game.

BLUNDER #4: LEAVING THE UNITED STATES? TAKE YOUR ASSETS WITH YOU

When an N.R.N.C. individual who may have spent time working or residing in the U.S. decides to return to his or her country of origin, failing to liquidate U.S. investment assets may lead to expensive procedures for foreign beneficiaries.

Understanding the U.S. Federal Estate Tax

The U.S. has a Federal estate tax that is imposed on death. The top rate of estate tax is 40%. Fortunately for U.S. citizens and noncitizens who are domiciled in the U.S., there is a generous U.S. exclusion from the estate tax. For 2024, they have a $13.61 million exclusion for an individual and a $27.22 million exclusion for a married couple. By contrast, for an N.R.N.C. individual. who owns property in the U.S., the estate tax exclusion is only $60,000 and an aggregate of $120,000 for a married couple. An estate tax treaty between the U.S. and a client's home country may occasionally expand that $60,000 exclusion.

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Who Must Pay the U.S. Federal Estate Tax

If the estate of a U.S. or non-U.S. citizen owes estate tax, the estate is generally liable for the estate tax. However, the estate may not have sufficient liquid cash, or the I.R.S. may be unable to access liquid assets outside the U.S. The I.R.S. has other recourse.

- An executor may be held *personally* liable for the estate tax if the executor distributed estate funds to the beneficiaries without retaining an amount to pay the U.S. estate tax.
- Beneficiaries of the estate who have received distributions from the estate can be personally liable for the estate tax, to the extent of the assets received.
- A U.S. bank, investment manager, mutual fund, or cooperative apartment house that gives estate property to the estate beneficiaries may be liable for the estate tax. Even if the decedent signed a transfer-on-death or beneficiary designation, or if the account or property is held jointly, the I.R.S. can impose the estate tax on the bank, investment manager or co-op apartment corporation that gave the property to the beneficiary before the estate tax was paid.
- A purchaser of U.S. real estate owned by the estate or heir of an N.R.N.C. individual should be certain that no U.S. or state estate tax lien exists on the real estate. An estate tax lien can remain attached to the property, and a title company may refuse to insure the title to the property.

This problem arises in the context of an N.R.N.C. individual who worked or resided in the U.S. for a time and returned home. To a lesser extent, the issue will also be relevant to the estate of a U.S. citizen who, during life, decide to retire outside the U.S.

Documentation Required to Distribute Real Property and Funds

It may be years before a decedent's estate tax is settled and the I.R.S. issues a closing letter to confirm that all U.S. estate tax has been paid. However, the estate beneficiaries may want or need their inheritance as soon as possible.

There are a few ways that a bank, investment manager or property manager can distribute estate property to beneficiaries and limit the institution's liability for the estate tax.

- **Local Executor or Estate Administrator.** Financial institutions can require the estate to petition a local probate court for the appointment of a U.S. executor or estate administrator. Where that occurs, a financial institution may distribute estate funds to the U.S. executor or estate administrator. This is possible because the executor or estate administrator will assume any liability for the estate tax, instead of the financial institutions. However, the financial institutions generally will not distribute estate funds to an executor or estate administrator who was appointed by a court outside of the U.S. Such a foreign executor or estate administrator would have to commence an ancillary court proceeding in the U.S. and be appointed the U.S. estate fiduciary by a U.S. court.
- **I.R.S. Transfer Certificate.** An alternative to a U.S. court proceeding is for the estate to apply for an I.R.S. "transfer certificate." This is a protracted

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procedure which requires the preparation of a U.S. estate tax return and the payment of any estate tax that is due. A transfer certificate can be required for the estates of both U.S. citizens and non-U.S. citizens who resided outside the U.S.

Each of the above procedures may also be available to a real estate manager such as a cooperative apartment house or a condominium association. They can require the court appointment of a local executor or estate administrator, an I.R.S. transfer certificate, and a release of any state estate tax lien. They all have some discretion. Banks, investment managers, co-op apartment houses, and real estate managers may require only a local executor or a transfer certificate. They could also require a Federal transfer certificate, state release of lien, and a court appointed U.S. executor or estate administrator.

The result can be a total stalemate and paralysis. A bank may not release any funds in advance of the issuance of an I.R.S. transfer certificate. However, the I.R.S. may not issue a transfer certificate until the estate pays the Federal estate tax. This becomes extremely problematic when the bank holds the only cash available to pay the estate tax.

Blunder

The estate or the heirs may incur extensive legal fees to liberate the estate funds and any U.S. real estate which the decedent owned at the conclusion of life.

Conclusion: Getting Money to Beneficiaries

If a departing U.S. citizen or N.R.N.C. individual wishes heirs to receive their inheritance in a timely way with minimal legal fees, financial assets should be transferred to a bank or investment manager outside the U.S. Real estate in the U.S. should be owned directly or indirectly by a foreign entity, which raises other issues that are beyond the scope of this article.

"The estate or the heirs may incur extensive legal fees to liberate the estate funds and any U.S. real estate which the decedent owned at the conclusion of life."

BLUNDER #5: DO NOT JUDGE A WILL BY ITS COVER

Occasionally, an attorney may draft a U.S. will for an international client who holds assets in more than one country. The attorney may pull a model will out of their file cabinet or off the computer and change the first page. This could involve adding a preamble on the first page stating that this will pertains only to U.S. property. The printed back of the will may declare that this is the client's "United States Will." Thus, both the front and back covers of the will indicate that it covers only U.S. property.

Inside the Will: Residuary Clause

While the will may contain several bequests or legacies, every well-drawn will invariably incorporates an omnibus clause called the Residuary Clause. This clause consolidates all property not explicitly bequeathed and distributes it to one or more individuals or charities, either outright or in trust.

Most Residuary Clauses begin with the phrase, "All the rest, residue and remainder of my property, wherever situated, I hereby give, devise, and bequeath to X, Y, and Z." The challenge arises in reconciling the declaration on page one of the will,

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specifying coverage limited to U.S. property, with the Residuary Clause, which covers all my property "wherever situated."

Blunder

The discrepancy between the front and back covers of the will and its contents poses a significant issue. An attorney or client might mistakenly assume that converting a standard will to one covering only U.S. property is straightforward, merely requiring a preamble on page one of the will. However, conflicts with other clauses within the will can arise, undermining the efficacy of such a preamble.

We recently administered the estate of a man born in a European country who spent over 20 years working in the U.S. During his time here, he established bank and brokerage accounts in the U.S. Before retiring and relocating to his home country, he signed a U.S. will. The preamble on the first page of this will indicated that it covered only his U.S. assets. However, the Residuary Clause contained conflicting language, stating that he bequeathed all remaining property "wherever situated" to a specific group of relatives.

Following the conclusion of the European individual's life, his family in Europe informed us that, as a young man, he prepared a will in Europe that left his European property to a select group of relatives. Those excluded from the earlier European will now sought inclusion in the Residuary Clause of his subsequent U.S. will, which bequeathed "all his property wherever situated" to include them and his European property.

The disappointed relatives under the early European will and those who received specific bequests under the decedent's later U.S. will have already spent tens of thousands of dollars on legal fees. Despite the passing of more than two years from the date of the decedent's death, not a single cent of the U.S. funds has been distributed to any of the relatives. There is yet to be a discussion of compromise or settlement in the U.S., and we are unaware of such negotiations taking place in Europe.

Conclusion: Avoiding the Blunder

In conclusion, the case of misaligned covers and content in will drafting serves as a stark reminder: never judge a will by its cover. The discrepancy between the Preamble and the Residuary Clause can lead to legal battles and financial strain for heirs.

To prevent such blunders, it is imperative for attorneys and international clients to meticulously examine every aspect of the will. Mere statements on the cover, both back and front, asserting the limitation of the will to property in the U.S. are inadequate. Each sentence must align with the intended scope and jurisdiction of the estate. Remember, the true essence of a will is not in its cover but in its content – a lesson vital for preserving the integrity of estate planning in the global arena.

FRENCH LIFE INSURANCE "101" – FOR U.S. PERSONS, RUN AWAY

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Tags
Foreign Life Insurance Policy
France
French Life Insurance Policy
French Taxation
Guideline Premium Limitation
P.F.I.C.
U.S. Taxation
Value Accumulation Test
Value Corridor Test

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INTRODUCTION

An individual takes out life insurance in order to provide for his heirs and to obtain peace of mind. Tax treatment for the individual during life and the heirs is straightforward when everyone resides in one country. But when a life insurance policy is written in France and the insured or the heirs are U.S. citizens or residents, what the policy holder, his estate, or the beneficiaries may encounter is anything but peace of mind. To their chagrin, each may find that he or she is in the crosshairs of contrary laws in two countries resulting in sub-optimal tax results. This article discusses the French and U.S. tax rules applicable to a French life insurance policy.

FRENCH LIFE INSURANCE POLICIES

A French life insurance policy is a contract under which the insurer receives payment of one or more premiums and undertakes the obligation to pay a capital sum or an annuity to a specified person at a specified date in the event of the death of the insured. The policy accumulates investment income, and the value grows tax-free.

Different Types of French Life Insurance Policies

The policy holder has choices between a single-support policy that is denominated in euros or a multi-support policy.

Single-support euro contracts offer policy holders the opportunity to invest their savings in a general or segregated asset commonly known as a "euro fund." The asset is managed by the insurance company and backed by a capital guarantee. The capital is protected from day-to-day no stock market fluctuations. Each year, the interest generated in the euro fund is distributed by the insurer to the policy holders. Corporate bonds represent more than 80% of the investments held by euro funds. In return for the security provided by these investments, returns are limited.

Multi-support contracts are not based on the euro, but on one or more units of account, the value of which may rise or fall. These contracts are known as "variable capital" contracts. Their value varies according to changes in the value of the units of account, themselves reflecting fluctuations in the benchmark stock or real estate markets. The insurer guarantees the number of units of account, but not their value during the term of the contract. The policy holder bears the investment risk.

Purpose of French Life Insurance Policies

Life insurance can be used for alternative purposes.

- It can be used for savings purposes to supplement retirement income. The policy holder saves the income generated under the policy while working

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and makes partial withdrawals from the policy to supplement income during retirement. It can also be used as precautionary savings vehicle that can be mobilized in the short term in case of need.

- It can be used to manage capital over the long term in a tax-privileged environment in order to supplement income through regular withdrawals or a life annuity.
- It can be used to pass on assets to surviving relatives in order protect loved ones in the event of death: It can provide appropriate solutions for preparing one's estate.

In France, the rules of civil inheritance law applies to the distribution of a decedent's assets. Forced heirship rules mandate that a certain portion of the estate – the "*reserve héréditaire*" – cannot be disposed during lifetime or at death to persons other than descendants, and under certain conditions, to a surviving spouse. But life-insurance policies are not covered by that rule. Policy holders can designate beneficiaries under certain conditions and limits, thereby bypassing French forced heirship laws.

DESIGNATION OF PARTICIPANTS

A life insurance contract brings together an insurer, a policy holder, an insured who usually is the policy holder and the beneficiaries.

The Policy Holder

The policy holder is often referred to as the "stipulator," the "contracting party," or the "subscriber." The policy holder is the person who signs the insurance policy and undertakes to pay the premiums stipulated in the insurance contract. He or she also has the exclusive right to designate the beneficiary.

The premium is calculated by the insurer, considering the insured's age, the duration and characteristics of the policy taken out, and its own administrative costs. Premium payment terms are purely contractual. The policy holder may be offered the choice of paying

- a single premium, payable at once when the policy is taken out;
- programmed premiums, paid regularly over the life of the contract; or
- premiums paid in instalments at the policy holder's discretion.

The latter is the most common option chosen at the present time.

When spouses are married under the French matrimonial regime of community of property ("*communauté de biens*"), a difficulty may be encountered regarding the power to dispose of joint funds by designating a beneficiary other than the surviving spouse. In comparison, the difficulty disappears if the premiums are paid from the policy holder's separate funds. An individual is free to dispose of separate funds to take out the life insurance policy. However, the subscriber must make a declaration of reinvestment if he wishes the life insurance policy itself to retain the status of separate property.

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Payment of premiums is optional, even if scheduled. The issuer of the policy has no means of compelling the policy holder to make payment.[1] In the event of non-payment of premiums, the insurer has several options:

- It may cancel the contract if the surrender value is insufficient.
- It may advance the policy holder the unpaid premium or fraction thereof, up to the surrender value the surrender value.
- It may reduce the contract if the surrender value is less than half the monthly minimum wage.[2]

The designation of the beneficiary belongs to the subscriber. It is a personal right, attached to the policy holder's status. In the event of the death of the policy holder before designation of the beneficiary, the solution depends on whether or not the policy holder is also the insured.

- If the policy holder is also the insured, the option to designate a beneficiary terminates. The contract is unwound, and its acquired value becomes part of the estate of the policy holder, with all related tax consequences. The policy holder's successors cannot act on his behalf retroactively.
- If the policy holder is not the insured, the contract is not terminated by death. The policy holder's heirs become joint policy holders of the life insurance unless one of the heirs is awarded the policy following a division of the estate. The new policy holders have the option of designating the beneficiary.

The Insured

The insured is the person whose death triggers the payout of the amount of the insurance contract. The policy holder and the insured are often the same person, but it is also possible to take out a policy on the life of another person. For example, a grandparent wishing to insure an annuity for grandchildren in the event of the death of their father will indicate the latter as the insured. In this case, the insured is the father and he must consent in writing to the capital or annuity initially guaranteed under the contract. Without that consent, the contract is null and void.[3]

The policy holder is not entirely free to choose the insured. The insured can only be a natural person. Moreover, the insured may not be a minor under the age of 12, an adult under guardianship, or a person placed in a psychiatric hospital.[4] Failure to comply with the limitations on the insured person renders the contract null and void. Moreover, the insurer and the policy holder are also liable to a fine of €4,500.

The Beneficiary

At the death of the insured person, the amount provided for in the contract is paid to the designated class of beneficiaries. The beneficiary can be either a natural person such as a descendent or a legal person such as an association, a foundation or an endowment fund. Only two rules limit the freedom to choose the beneficiary of a life insurance contract.

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[1] Article L132-20, al. 1 of the French Insurance Code.

[2] Article R132-2 of the French Insurance Code.

[3] Article L 132-2 of the French Insurance Code.

[4] Article L 132-3 of the French Insurance Code.

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- The beneficiary may not be a member of a class prevented from being beneficiaries of the decedent, such as a physician who treated the insured individual during the final illness.
- The beneficiary must not have an immoral or illicit purpose.

In the event that the beneficiary clause is deemed null and void, the contract is deemed to have been drawn up without a named beneficiary. In that case, the beneficiary is the person or persons who are in a class that has been sufficiently defined in the stipulation to be identified when the guaranteed capital or annuity becomes payable.

"In the event that the beneficiary clause is deemed null and void, the contract is deemed to have been drawn up without a named beneficiary."

For example, the following meets the condition of designated beneficiary:

- The designation relates to the born or unborn children of the contracting party, the insured, or any other designated person.
- The designation relates to the surviving spouse.
- The designation relates to the "heirs of the insured or of a predeceased beneficiary.[5]

A beneficiary clause that is imprecise or ambiguous as to the identity of the beneficiary can place the insurer in a delicate situation. If the insurer wrongfully refuses to pay the designated beneficiary, the insurer may be liable to pay penalties of up to three times the legal interest rate.[6] Moreover, if the insurer pays the funds to the wrong beneficiary, the insurer is not released from its obligation toward the actual beneficiary.

It is not mandatory to include a beneficiary clause in a policy. Nonetheless, it is almost always included. In the absence of a specific or determinable beneficiary, the amount to be paid out goes to the policy holder's estate and is subject to inheritance tax. In comparison, a life insurance payout receives favorable tax treatment when it is linked to a specified beneficiary.[7] Once a beneficiary is designated, the capital or annuity does not form part of the insured's estate.[8]

While the absence of a beneficiary designation is most often involuntary and results from an oversight or a combination of unfavorable circumstances, it can sometimes be voluntary. For example, a choice may be made in favor of a transfer subject to inheritance tax, rather than life insurance, when the latter is lower than the 20% or 31.25% levy, or when the beneficiaries are resident in France and the insured policy holder has moved to a foreign country where the value of the life insurance policy is subject to inheritance tax.

The beneficiary's acceptance is not required for the contract to be valid. Nor is it necessary for the beneficiary to be informed of the existence of the contract drawn up for his or her benefit. But the beneficiary's acceptance has important consequences, since the policy holder cannot change the identity of the accepted beneficiary without the latter's agreement and no withdrawal or advance can be made without the agreement of the accepting beneficiary.

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[5] Article L 132-8 of the French Insurance Code.

[6] Article L 132-23-1 of the French Insurance Code: see no. 28427.

[7] Article L 132-11 of the French Insurance Code.

[8] Article L 132-12 of the French Insurance Code.

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When the policy is terminated, the capital sum or annuity is paid to the beneficiary, provided the latter accepts the benefit of the policy. A beneficiary has three months to accept the benefit of the policy once formal notice has been given.[9] Beneficiaries have ten years to claim any sums due to them, from the date on which they became aware of the death.

FRENCH TAXATION AT VARIOUS POINTS

In terms of French life insurance taxation, three situations can be distinguished: (i) withdrawals (ii), the death of the policy holder, and (iii) and the conversion of the capital into a life annuity.

French Taxation Upon Withdrawal

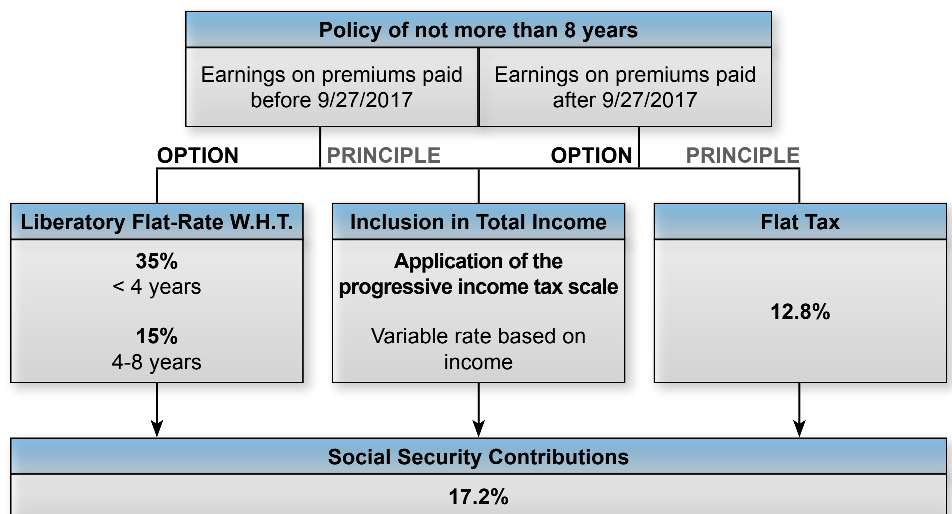
Policy Outstanding Not More Than Eight Years

The tax treatment arising from a withdrawal depends on the date of payment of the premiums and the date of the withdrawal.

- For premiums paid up to September 26, 2017, a choice must be made between a flat withholding tax and the tax bracket of the individual. The flat rate of withholding tax is 35% if the withdrawal takes place in the first four years of the policy. If the withdrawal is made in years five through eight, the flat rate of withholding tax is 15%. If the flat rate of withholding tax is chosen, no further tax is due.
- For premiums paid beginning on or after September 27, 2017, a choice must be made between a single flat-rate withholding tax of 12.8% and the and the tax bracket of the individual.

In all circumstances, social charges of 17.2% must be paid.

The following diagram illustrates the tax that may be due for withdrawals of premiums held for not more than eight years and made before September 27, 2017, and for comparable withdrawals made on or after that date.



9 Article L 132-9, I-al. 2, of the French Insurance Code.

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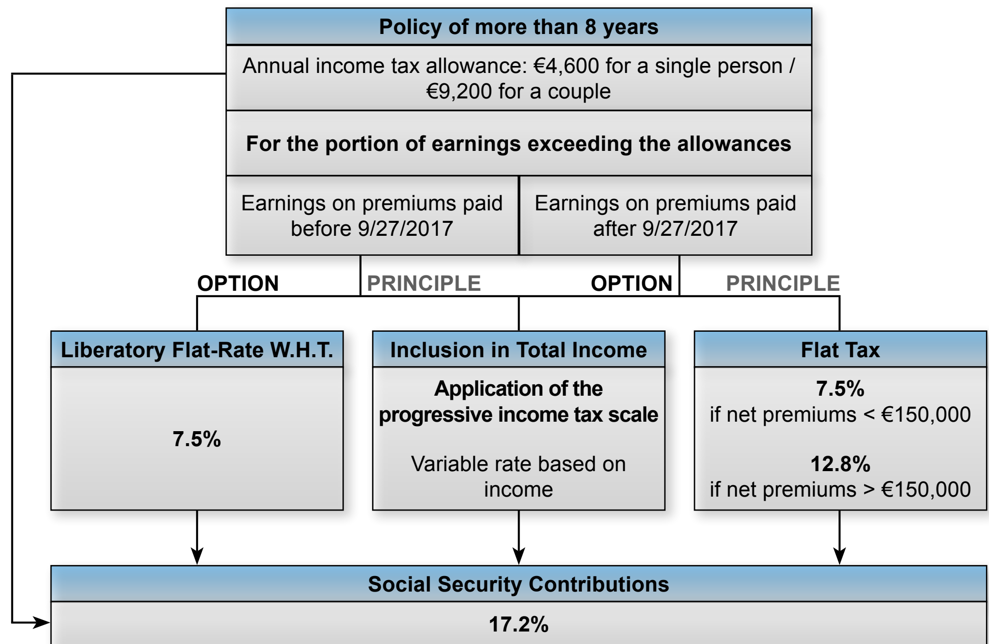
Policy Outstanding More Than Eight Years

The tax treatment arising from a withdrawal depends on the date of payment of the premiums and the date on which premiums are paid.

- For premiums paid up to September 26, 2017, an annual tax-free allowance of €4,600 is allowed for single individuals. The tax-free annual allowance is €9,200 for married couples or couples that register a civil union. Gains in excess of the annual allowance are subject to a flat rate of withholding tax of 7.5%.
- For premiums paid on or after September 27,2017, an annual tax-free allowance of €4,600 is allowed for single individuals. The tax-free annual allowance is €9,200 for married couples or couples that register a civil union. Gains in excess of the annual allowance are subject to a flat rate of withholding tax of 7.5% withholding tax for the portion of the gains related to to net premiums paid of not more than €150,000. The rate increases to 12.8% withholding tax for the portion of the gains related to net premiums paid in excess of €150,000.

In all circumstances, social charges of 17.2% must be paid.

The following diagram illustrates the tax that may be due for withdrawals of premiums held for more than eight years and made before September 27, 2017, and for comparable withdrawals made on or after that date.



In the U.S.-France tax context, the treaty provisions relating to interest income apply for life insurance income. Article 11 generally provides that interest income is taxable only in the state of residence of the recipient. Article 11 applies to income from the withdrawal of premiums under a life insurance policy. If the recipient of the income resides in the U.S., French tax will not be imposed.

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Taxation upon Death of the Insured

The date and age of the insured at the time the premiums are paid will determine whether the capital can be transferred to beneficiaries at the date of death of the insured individual with or without inheritance tax.

- For premiums paid before the age of 70 years old, inheritance tax of 20% is due, capped at €700,000, then 31.25%, after an allowance of €152,500 per beneficiary.[10]
- For premiums paid after the age of 70 years old, inheritance tax is due for all such premiums that are in excess of an overall allowance of €30,500.[11]

Interest and capital gains on life insurance policies are exempt from inheritance tax at the policy holder's death.

The France-U.S. Estate, Inheritance, and Gift Tax Treaty does not apply to this specific taxation. The levy is not owed when, on the date of death, the policy holder was not a resident of France for inheritance tax purposes unless the beneficiary is a resident of France on the date of death and was a resident of France for at least six of the ten years preceding the death.

French Taxation at the Conversion to a Life Annuity

Life insurance allows the conversion of the capital into a life annuity: the insurer guarantees to pay the policy holder an annuity until death. Payments may be made on a monthly, quarterly, or half-yearly basis. The conversion to a life annuity is irreversible. The policy holder permanently loses control of the capital accumulated in the life insurance policy and the life insurance policy cannot be transferred to beneficiaries at death of the insured.

The amount of the annuity depends on the amount of capital in the contract and the age of the policy holder at the time of conversion. The annuity payments are subject to income tax and social contribution when and as made. The taxable portion of the annuity depends on the subscriber's age when the annuity is triggered, and is fixed for the balance of the annuitant's lifetime. The taxable portion of the annuity payment is fixed as follows:

- 70% if the conversion occurs under the age of 50 years
- 50% if the conversion occurs between the ages of 50 and 59 years
- 40% if the conversion occurs between the ages of 60 and 69 years
- 30% if the conversion occurs over the age of 69 years

USUFRUCT/BARE LEGAL TITLE ARRANGEMENT

Under French law, ownership of an asset may be divided into two portions. One is the ownership of the income from the property, known as a *usufruct* interest. The holder of the *usufruct* interest is often referred to as the "*usufructuary*." The other

[10] Article 990 I of the French General Tax Code.

[11] Article 757 B of the French General Tax Code.

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is the bare legal ownership of the asset itself. In very broad terms, the bare legal ownership can be analogized to a tree and the *usufruct* interest can be analogized to the fruit of the tree. Where property is owned pursuant to a *usufruct* arrangement, ownership is said to be "dismembered." Typically, the split ownership is united at the death of the holder of the *usufruct* interest.

Ownership of a life insurance product can be dismembered. The *usufruct* interest can be created at the time of an asset's acquisition .Similarly, it can be created during t he course of ownership. Both are discussed below.

***Ab Initio* Dismemberment**

In an *ab initio dismemberment*, one of the subscribers to a life insurance policy subscribes to the *usufruct* interest and the other subscribes to the bare ownership interest. The funds that are used to subscribe generally come from the reinvestment of the sale proceeds received from the sale of another dismembered asset. As mentioned above, the *usufruct* is extinguished by the death of the *usufructuary*, and the joint bare-owner becomes the full owner of the policy.[12]

From a tax point of view, inheritance tax is not payable under article 1133 of the French General Tax Code, which states that the reunification of *usufruct* and bare ownership does not give rise to any tax when this reunification takes place at the end of the period initially set for the *usufruct* arrangement or at the death of the *usufructuary*.

Dismemberment of the Beneficiary Clause

On the other hand, the full owner of the life insurance policy may decide to divide the beneficiary clause between a bare owner and a *usufructuary*. In the most common case, where the policy is settled in cash rather than units of account, the dismemberment of the beneficiary clause gives the beneficiary a quasi-*usufruct* over the sums paid in.[13] On the death of the insured, the insurer must pay the guaranteed capital sum to the *usufructuary*, who must then return an equivalent sum to the designated bare owner at the end of the *usufruct*.

The bare owner and the *usufructuary* are considered beneficiaries in proportion to their share of the sums paid out by the insurance company. This share is determined in accordance with the life *usufruct* scale set out in article 669 of the French General Tax Code. For premiums paid before the age of 70 years old, the €152,500 allowance is also distributed according to the scale set out in article 669 of the French General Tax Code.

However, where one of the beneficiaries is exempt from the levy, such as where the surviving spouse is designated as the *usufructuary* beneficiary, the tax authorities refuse to allow the exempt beneficiary's share of the allowance to be used by the non-exempt beneficiaries.[14]

For premiums paid after the age of 70 years old, the deduction of €30,500 – which is shared when there are several beneficiaries – must be divided between the *usufructuary* and the bare owner according to the same scale that appears in article 669 of

[12] Article 617 of the French Civil Code.

[13] Article 587 of the French Civil Code.

[14] BOI-TCAS-AUT-60 no. 310.

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the French General Tax Code. If one of the joint beneficiaries is exempt – again as is the case of a surviving spouse designated as the *usufructuary* – the bare owner can benefit from the full €30,500 allowance.[15]

Tax Treatment of the Restitution Claim

On the death of the *usufructuary*, the split-ownership of the beneficiary clause can result in the recognition of a liability that can be deducted under certain conditions from the estate when calculating inheritance tax. The amount of the liability corresponds to the amount due to the bare owners in respect of their restitution claim.

> ***“. . . a French life insurance policy is not disqualified per se from being a life insurance policy for U.S. tax purposes, however, it must meet at least one of the two tests mentioned above to qualify for beneficial U.S. tax treatment.”***

LIFE INSURANCE DEFINED FOR U.S. TAX PURPOSES

A life insurance contact for U.S. tax purposes is a contract that is a life insurance contract under the “applicable law,” provided one of the following two tests are met.[16] The tests are the cash value accumulation test and the Guideline Premium Limitation / Cash Value Corridor Test.

Applicable Law

The phrase “applicable law” has not been defined in the Code, however, the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84 (December 31, 1984), prepared by the Staff of the Joint Committee of Taxation (“J.C.T.”), states that the law may be foreign law.

> A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement.[17]

Therefore, a French life insurance policy is not disqualified *per se* from being a life insurance policy for U.S. tax purposes, however, it must meet at least one of the two tests mentioned above to qualify for beneficial U.S. tax treatment.

Cash Value Accumulation Test

This test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts.

The cash value accumulation test looks to the cash surrender value of the contract which is compared to the net single premium amount.[18] The cash value accumulation test is met if the cash surrender value of the contract, by its terms, may not exceed the net single premium that would have to be paid at such time to fund the future benefits under the contract assuming that the contract mature no earlier

[15] BOI-ENR-DMTG-10-10-20-20 n° 220.

[16] Code §7702(a).

[17] JCS-41-84 at page 646.

[18] *Id.* at page 647.

than age 95 for the insured.[19] The test must be met at all times during the life of the insurance contract. The net single premium is a one-time payment that guarantees coverage for the policy holder without any additional expenses or fees.[20]

The cash surrender value is computed without regard to any surrender charges, policy loans, or reasonable termination benefits.[21]

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time is computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the "rate or rates guaranteed on the issuance of the contract" means the interest rate or rates reflected in the contract's nonforfeiture values (*i.e.*, the cash surrender value), assuming the use of the method in the Standard Nonforfeiture Law.

Guideline Premium Limitation / Cash Value Corridor Test

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment[22] through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (*i.e.*, premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns.

The test is a two-part test that applies to both the premiums and the cash value.

The guideline premium requirement requires that the net premiums paid at any time cannot exceed the greater of (1) the single premium that would have been required upon issuance of the policy that is needed to fund the future benefits under the contract[23] or (2) the sum of the level annual premiums that would be required for that purpose over the life of an insured who lives until at least age 95.[24] A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment.

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[19] Code §7702(b)(2). The future benefits to which this rule refers include death benefits, endowment benefits, and additional benefits for which the insured has paid.

[20] The net single premium is computed using the rate guaranteed in the contract that cannot fall below 4% and the mortality charges specified in the contract. If the contract is silent on the charges, the mortality charges used for computing statutory reserves are used to compute the premium amount.

[21] Code §7701(f)(2).

[22] JCS-41-84 at page 649.

[23] Code §§ 7702(a)(2)(B), 7702(c)(1), 7702(c)(2)(A), 7702(c)(3)(A).

[24] Code §§ 7702(a)(2)(A), 7702(c)(1), 7702(c)(2)(B), 7702(c)(4).

The cash value corridor test requires that the death benefits under the contract must always be more than an applicable percentage of the cash surrender value. The percentages appear in a statutory table that looks to the insured's age at the beginning of the contract year and provides a percentage that must be used, ranging 250% for individuals who are not over age 40 on the first day of the contract year to 100 to 105% for individuals who are between age 90 and age 95 on the first day of the contract year.[25] The legislative history illustrates the application of the cash value corridor as follows.

> Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000). [26]

The two tests are extremely complicated and require actuarial estimations beyond the ability of most tax advisers. Thus, it is best to have the assistance of the insurance company's own actuaries.

If a life insurance policy meets at least one of the two tests, it is treated as a qualified policy subject to preferential tax treatment in the U.S. including the benefit of tax deferral. If a policy is an unqualified policy, the benefit of tax deferral is not available and the policy holder may be subject to immediate taxation.

U.S. TAXATION OF A QUALIFIED LIFE INSURANCE POLICY

A qualified life insurance policy is granted preferential tax treatment. The most substantive benefit is the nonrecognition of any annual appreciation in the surrender value and full exemption from tax on the proceeds on death to the extent they represent death benefits. A total list of benefits is as follows:

- **Annual Build Up:** The year-to-year increase in the cash value is not subject to income tax.
- **Death Benefit:** Proceeds attributable to the death benefit of the life insurance contract are not subject to income tax in the hands of the estate or heirs receiving the payment.[27]
- **Dividends:** No U.S. tax is imposed if dividends are retained by the insurer as a premium. If not retained by the insurer, a distribution reduces the investment in the contract and is not taxed to the and is not taxed until the full investment is returned to the insured. At that point, the excess is fully taxed as ordinary income at rates of up to 37% under current law. The investment in the contract is the aggregate amount of premiums paid into the policy reduced by the aggregate amount received as distributions under the contract that were previously excluded from gross income (*e.g.*, prior tax-free withdrawals).

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[25] Code §7702(d).

[26] JCS-41-84 at pages 650-651.

[27] Code §101(a).

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- **Withdrawal or Surrender:** Upon a payout before death, the amount in excess of the "*investment in the contract*" is subject to U.S. tax as ordinary income at the rate of up to 37%.
- **Sale of Policy:** Proceeds from the sale of a life insurance contract to a third party are taxed as follows. Amounts received are exempt from U.S. tax up to the investment in the contract. Any amount received above the investment in the contract (tax basis) up to the cash value is taxed as ordinary income. All remaining proceeds are taxed as capital gains.

U.S. TAXATION OF AN UNQUALIFIED INSURANCE POLICY

As discussed above, a French life insurance contract typically is not designed to provide a death benefit. Rather, it serves as an investment tool for the owner of the policy. Consequently, it likely will not meet either test relevant to determine whether a policy is a qualified policy for U.S. tax purposes.

In general, a contract that is a life insurance contract under applicable law that fails to meet the tests under Code §7702 continues to be a life insurance contract for all purposes of the Code except for the following two purposes:[28]

Annual Build-Up in the Policy Value is Subject to U.S. Tax

The income on the contract for any taxable year of the policy holder is taxed as ordinary income by the policy holder during such year.[29]

The income on the contract is the increase in the net surrender value of the contract during the taxable year as (i) increased by the cost of life insurance protection provided under the contract during the taxable year and (ii) reduced by the premiums paid under the contract during the taxable year.[30]

No foreign tax credit is available in the U.S. since no French income tax is due on the annual buildup.

Taxation of Death Proceeds

A portion of the death benefit will be received free of income tax, and the balance will be taxed as ordinary income at rates of up to 37%.[31] For this purpose, the death benefits are divided into two parts. The proceeds, to the extent of the net surrender value, are treated as amounts received under an annuity contract and are includible in the recipient's gross income as ordinary income.[32] The excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract is received tax free under Code §101.

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[28] Code §7702(g)(3).

[29] Code §7702(g)(1)(A).

[30] Code §7702(g)(1)(B).

[31] Code §7702(g)(2).

[32] Clarified by the French government here.

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Withdrawal or Surrender

Upon a payout before death, the amount in excess of the "investment in the contract" is subject to U.S. tax as ordinary income. The excess is also taxed in France if the policy holder is a French resident. The income is treated as interest income taxed as ordinary income.

As mentioned above on page 32, Article 11 (Interest) of the France-U.S. income tax treaty grants exclusive right to tax to the country of residence of the recipient. Thus, a U.S. citizen who resides in France will be subject to French tax under the treaty. He or she will also be subject to U.S. tax under the saving clause of the treaty.[33] The income will be foreign source for U.S. tax purposes since interest is sourced to the country of payor. Therefore, the policy holder will be entitled to claim a foreign tax credit for the French taxes paid on that income.

Sale of Policy

Proceeds from the sale of an unqualified life insurance contract to a third party are treated as follows:

- Amounts received are exempt from U.S. tax up to the investment in the contract.
- Any amount received above the tax basis up to the cash value is taxed as ordinary income.
- All remaining proceeds are taxed as capital gains.

Article 13(6) of the Treaty grants exclusive right to tax to the country of residence of the seller. Thus. a U.S. citizen who is a French tax resident will be subject to French income tax under the treaty but will also be subject to U.S. tax under the saving clause. The income will be foreign source for U.S. tax purposes if U.S. citizen has a tax home in France.[34] Therefore, the policy holder will be entitled to claim a foreign tax credit of the French taxes paid against his U.S. income tax liability.[35]

However, French law allows only a partial withdrawal or a complete surrender of the policy. It does not allow for a sale of a policy.

Excise Tax on Foreign Life Insurance Premium

An excise tax of 1% is imposed on insurance premiums paid to a foreign life insurance company insuring U.S. risks.[36] At the same time, premiums subject to the excise tax are exempt from the 30% F.D.A.P. withholding tax.[37] The person making a premium payment files Form 720 (Quarterly Federal Excise Tax Return) and remits the excise tax to the I.R.S.

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[33] Paragraph 2 of Article 29 (Miscellaneous Provisions).

[34] Code §865(a).

[35] Re-sourcing rules under the treaty must be examined if the policy holder has a tax home in the U.S.

[36] Code §4371.

[37] Treas. Reg. §1.1441-2(a)(7).

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The excise tax does not apply in either of the following circumstances:

- The premiums generate effectively connected income for the foreign insurance company.
- The premiums are exempted from the excise tax under an applicable income tax treaty.

The France-U.S. Income Tax Treaty includes the excise tax as a covered tax.[38] Therefore, since the insurance premiums would be considered business profits in the hands of the insurance company, the excise tax exposure will not arise in the U.S. in the absence of a permanent establishment in the U.S.

To qualify for the exemption, the foreign life insurance company must meet three conditions:

- It must enter into a closing agreement with the I.R.S.
- It must be a resident of France.
- It must meet one of the tests under the Limitation on Benefits provision.

The I.R.S. publishes a list of foreign life insurance companies that have entered into qualifying closing agreements.[39]

U.S. Policy Holders / Form 8621 / P.F.I.C.'s Held by French Insurance Company

Premiums paid under a life insurance policy to a French insurance company are used by the company to make investments. If an investment takes the form of collective investment vehicles (among which are *Organisme de Placement Collectif en Valeurs Mobilières*, (O.P.C.V.M.'s)), the collective investment vehicle likely will be categorized as a Passive Foreign Investment Company ("P.F.I.C.").

However, a U.S. policy holder of a French life insurance policy will be required to report the P.F.I.C.s and include income therefrom only if he or she is treated as a direct or indirect shareholder in the P.F.I.C. The report is filed on Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.). In the circumstances, the question presented is whether the owner of the policy is considered to be an indirect shareholder of a P.F.I.C. in which the French insurance company holds shares. An indirect shareholder of a P.F.I.C. is determined based on certain attribution rules. Attribution of ownership of a P.F.I.C. from a foreign corporation to a shareholder is possible under two situations:

- The foreign corporation is itself a P.F.I.C.[40]
- The foreign corporation is not a P.F.I.C. and the shareholder owns 50% or more in the value of the foreign corporation.

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38 Article 2 (Taxes Covered), Paragraph 1(a) (ii). Note, however, the treaty benefit is lost if, and to the extent, the risk is reinsured with a company based in a country that has not entered into an income tax treaty with the U.S. that provides comparable benefits regarding the excise tax in the U.S.

39 See here.

40 In this case, the ownership percentage of a shareholder in the foreign corporation holding a P.F.I.C. is irrelevant.

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In general, active foreign insurance companies are not considered to be P.F.I.C.'s under the active insurance exception to P.F.I.C. status.[41] As a result, a French life insurance company should not be treated as a P.F.I.C. and attribution under the first attribution rule is inapplicable. Attribution is also unwarranted under the second attribution rule because a French life insurance company is not a P.F.I.C. When a foreign company is not a P.F.I.C., its investment in a lower-tier foreign company that is a P.F.I.C. may be attributed only to a U.S. person that is a 50% shareholder of the foreign corporation, which is outside the fact pattern presented.

In view of the above, a policy holder of a French life insurance policy should not be viewed to be an indirect owner of shares in a P.F.I.C. held by a French life insurance policy. The policy holder should have no P.F.I.C. exposure in the facts presented.

The conclusion is buttressed by Rev. Rul. 2003-91, which addresses whether, for U.S. income tax purposes, the holder of a variable life insurance contract would be considered to be the owner of the assets that fund the variable contract. In the ruling, the policy holder purchased a life insurance contract under which he specified the allocation of the premium among available subaccounts maintained by the insurance company. The holder could change the allocation of premiums at any time within certain limitations, but had no legal or inferred rights regarding the investment strategy of any investment account or the assets to be held by a particular account. All investment decisions concerning the investment accounts were made by the insurance company and its investment advisor.

The I.R.S. concluded that the policy holder did not have any legal, equitable, direct, or indirect interest in any of the assets held in an investment account. Therefore, interest, dividends, and other income derived from the assets that fund the variable contract cannot be included in the holder's gross income when and as earned under the policy.

U.S. Reporting Obligation for the Foreign Life Insurance Policy

Every U.S. tax resident and every U.S. citizen must annually report all interests held in all foreign financial accounts if the aggregate value of all foreign accounts at any time exceed $10,000. The report is made to the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Treasury Department. FinCEN Form 114 (Report of Foreign Bank and Financial Accounts (F.B.A.R.)) is the form used to make the report.

The definition of "foreign financial accounts" includes an account that is an insurance or annuity policy with a cash surrender value. A French life insurance policy constitutes a foreign financial account for F.B.A.R. purposes. Consequently, a U.S. person who holds a French life insurance policy must report the investment in the policy on an F.B.A.R. if the dollar threshold is met.

In addition for F.B.A.R. reporting to FinCEN, a U.S. taxpayer must report the investment on I.R.S. Form 8938 (Statement of Specified Foreign Financial Assets) provided that the life insurance policy is a cash value insurance policy having a positive value and the aggregate value of all foreign financial assets held by the U.S. taxpayer exceeds a specified threshold that varies based on the marital status of the individual and place of physical residence.

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[41] Code §1297(b)(2)(B).

CONCLUSION

As the world gets smaller and investment opportunities cross borders, it is easy to ignore the complexities of tax laws and commercial laws in other countries. As evidenced in this article, a safe investment in a life insurance contract issued under the laws of a foreign country brings with it a world of complexities that are easy to miss in the absence of competent cross border tax planning.

“. . . a safe investment in a life insurance contract issued under the laws of a foreign country brings with it a world of complexities that are easy to miss in the absence of competent cross border tax planning.”

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THE AFTERMATH OF *YA GLOBAL*: WHO IS A PARTNER?

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Tags
Code §1446 Withholding
Effectively Connected Income
Partner
Partnerships
Service Provider
YA Global

INTRODUCTION

The *YA Global* case has drawn widespread attention due to the U.S. tax implications for foreign investment entities investing in U.S. securities or making use of a U.S. investment manager. The I.R.S. prevailed in the U.S. Tax Court, and the foreign investment entity was found to have been engaged in the conduct of a U.S. trade or business in the facts presented. The Tax Court has now released a memorandum opinion[1] (the "Follow-up Opinion") that addresses the following question: what standard should be applied when determining whether a purported partner should be recognized as a partner for income tax purposes? In the context of the *YA Global*, the answer controls whether a distribution to a non-U.S. person is subject to withholding tax under Code §1446.

BACKGROUND

YA Global, the taxpayer in the case, was a Cayman Islands investment entity that was classified as a partnership for U.S. income tax purposes. It provided funding to portfolio companies in exchange for stock, convertible debentures, promissory notes, and warrants.

Because YA Global had no employees, it retained Yorkville Advisors ("Yorkville"), a U.S. corporation, to manage its assets. Yorkville also served as YA Global's general partner. YA Global could impose restrictions from time to time on the management of its assets with appropriate notice to Yorkville.[2] As part of the transactions in which YA Global acquired securities from portfolio companies, those companies paid fees to both YA Global and Yorkville.

For each of the years in issue, YA Global filed Form 1065 (U.S. Return of Partnership Income) but did not file Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)), a form used to report withholding tax on a foreign partner's share of effectively connected income of a partnership. Ultimately, the I.R.S. issued notices of final partnership administrative adjustment ("F.P.A.A.'s"), the equivalent of deficiency notices in the context of a partnership. The F.P.A.A.'s asserted the YA Global was engaged in the conduct of a trade or business in the U.S., that all of its taxable income was effectively connected with that trade or business, and that YA Global was liable for withholding tax under Code §1446 on the portion of the partnership's effectively connected income ("E.C.I.") allocable to its foreign partners.

[1] T.C. Memo. 2024-78.

[2] As Yorkville was both the general partner of YA Global and the asset manager engaged by YA Global, the importance of the notice for income tax purposes seems to be limited to form rather than substance.

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The F.P.A.A.'s also determined that YA Global was a dealer in securities, meaning it was subject to the mark-to-market accounting rules of Code §475.

In a previous opinion,[3] the Tax Court held that the activities of Yorkville were attributable to YA Global in the sense that Yorkville was acting as YA Global's agent. YA Global's ability to give interim instructions to Yorkville regarding the management of YA Global's account demonstrated a relationship between an agent and principal. The activities that Yorkville conducted on behalf of YA Global were continuous, regular, and engaged in for the primary purpose of income or profit.

The Tax Court also held that YA Global regularly purchased securities from customers in the ordinary course of a trade or business. Consequently, it accepted the I.R.S. assertion that YA Global was a dealer in securities and was subject to the mark-to-market rule. Moreover, all of YA Global's income was properly treated as E.C.I.

WHO IS A PARTNER?

In the Follow-up Opinion, the Tax Court addressed several residual issues.[4] Among the most notable was the question of determining when a partner of YA Global converts to being a nonpartner. The question became particularly relevant following the Tax Court's initial decision because of the relevance of the partnership withholding rules in Code §1446.

Code §1446 requires a partnership that reports E.C.I. to pay a withholding tax on "effectively connected taxable income" ("E.C.T.I.") allocable to foreign partners. Withholding tax generally is collected at the highest possible tax rate specified in Code §1 for individual partners or the tax rate in Code §11 for corporate partners. In the event withholding tax exceeds the actual tax, a refund is available, provided a tax return is filed. A partnership that fails to withhold as required is liable for the tax owed unless the relevant foreign partner pays the tax. In either case, interest and penalties will still apply to the partnership.[5] Alternatively, the partnership's liability for the withholding tax is waived if it can demonstrate that the tax liability was zero.[6]

Investors in YA Global directly held interests in one of two feeder funds, depending on the status of the investor. U.S. investors held interests in YA Onshore, and foreign investors held their interests in YA Offshore. Yorkville, the general partner and investment manager of YA Global, established several special purpose vehicles ("S.P.V.'s") to allow investors to redeem their investments. An investor seeking redemption was given the option of receiving an in-kind distribution of securities or an ownership interest in an S.P.V., which conferred "*pro rata* participation interests" in YA Global's portfolio of securities.[7] The S.P.V.'s received cash distributions when YA Global liquidated its securities. YA Global issued Schedule K-1's to YA Offshore and the S.P.V.'s, suggesting that YA Global viewed the S.P.V.'s as partners in YA Global.

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[3] *YA Global Investments, LP v. Commr.,* Nos. 14546-15 and 28751-15, 161 T.C. (2023).

[4] T.C. Memo. 2024-78.

[5] Code §1463.

[6] Treas. Reg. §1.1446-3(e)(2).

[7] YA Global did not provide detail on what these participation interests entailed.

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The I.R.S. conceded that YA Offshore's tax liability, and therefore YA Global's withholding liability, had been zero. However, the I.R.S. argued that YA Global failed to withhold tax due for the S.P.V.'s, identified as the other purported foreign partners.

Before addressing substantive arguments, the court dealt with a procedural matter. The I.R.S. took issue with the fact that YA Global asserted that the S.P.V.'s were not partners. While the court agreed that this was a violation of procedural rules, it felt justified in dealing with the substantive arguments because any inadequacy of evidence (owing to the issue having not been brought up at an earlier point in the controversy) would only harm YA Global, the party making the argument.

The court first considered the participation rights that the S.P.V.'s carried. It surmised that if the participation rights merely gave ownership interests in the securities held by YA Global, the S.P.V.'s were not partners. But the Schedule K-1's showed the S.P.V.'s were allocated income and losses from YA Global, indicating that the S.P.V.'s rights might include contractual rights to share in YA Global's revenue. The court found no evidence indicating otherwise.

"Before addressing substantive arguments, the court dealt with a procedural matter . . ."

FORMER CODE §704(e)(1) VS. *CULBERTSON*

The court turned to the question of the appropriate test for identifying a partner. During 2009, the tax year in question, Code §704(e)(1) provided the following definition of partner:

> A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.[8]

The regulations define a "capital interest" as follows:

> For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership.[9]

Based on the plain reading of the statute in combination with the Schedule K-1's that were issued, it would appear that the S.P.V.'s were partners. However, YA Global asserted that Code §704(e)(1) contained an additional requirement under which the provision would impute partner status only if the holder of the capital interest intended to join in the conduct of the partnership's business.

This requirement is not found in the text of the provision. Instead, YA Global's argument was based on two older Supreme Court cases involving family partnerships. Family partnerships were viewed with suspicion by the I.R.S. because they could be used to "escape surtaxes by dividing one earned income into two or more."[10]

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[8] This provision was repealed in 2015.

[9] Treas. Reg. §1.704-1(e)(1)(v).

[10] *Commr. v. Tower*, 327 U.S. 280 (1946).

Commr. v. Tower

In the first case, *Commr. v. Tower*, a husband transferred several shares of a corporation to his wife, after which both contributed their shares to a partnership. The Supreme Court upheld the Tax Court's conclusion that the wife was never a partner because the husband and wife never intended to carry on business as a partnership. The court found that the wife neither invested her own capital nor provided vital services such as control and management of the business to the purported partnership.

Culbertson v. Commr.

On similar grounds, the Tax Court found in *Culbertson v. Commr.*[11] that a father and his four sons did not enter into a partnership. However, the Supreme Court remanded the case, advising that the contribution of vital services or original capital was not a necessity to the formation of a partnership:[12]

> The question…is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

In other words, the most important inquiry was the intent of the possible partners rather than the nature of what they contributed.

The *YA Global* court suggested that former Code §704(e)(1) was enacted as a response to these cases: Congress wished to steer the definition of a partner in a partnership to a more objective standard. This responded to YA Global's argument that former §704(e)(1) was never intended to provide an alternative test to *Culbertson*. In fact, legislative history indicates that one reason Congress ultimately repealed the provision was the worry that it did create such an alternative.[13]

One court case that hinted at this concern was *TIFD III-E Inc. v. U.S*.[14] There, the 2nd Circuit found that no partnership existed under *Culbertson* but instructed the district court to apply former §704(e)(1). The case left open the possibility that a nonpartner under *Culbertson* might be a partner under Code §704(e)(1).[15]

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[11] 6 T.C.M. (CCH) 692 (1947).

[12] 337 U.S. 733 (1949).

[13] Pub. L. No. 114-74.

[14] 459 F.3d 220 (2006).

[15] In that case, the district court found a partnership existed under §704(e)(1) but was reversed again by the 2nd Circuit, which found that the purported partners' interests were debt interests rather than capital interests.

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The Tax Court in *YA Global* ultimately found that §704(e)(1) required the recognition of the S.P.V.'s as partners based on their rights to proceeds from the sale of securities owned by YA Global.

<u>Application of *Culbertson*</u>

The court nonetheless entertained YA Global's request to use *Culbertson* as the proper test, but reached the same conclusion. Based on the reasoning of *Culbertson*, YA Global argued that because the S.P.V.'s were a means for investors to redeem their investments, the S.P.V.'s had no intent to carry on with YA Global's business.

In response, the court first noted that the participation rights suggested an intent to continue with the business while also distinguishing between the investors' intent and the S.P.V.'s' intent. Moreover, the court characterized YA Global's position as the proposition that a partner ceases to be a partner "simply by announcing an intention to withdraw from the partnership," which the court described as a false premise. Instead, under the principles of Code §736, the court observed that a withdrawing partner remains a partner until the partner receives his or her final payment.

Finally, YA Global argued that to the extent that the S.P.V.'s were allocated income, they were acting in a nonpartner capacity under Code §707. Code §707 characterizes certain payments from a partnership to a partner as compensation income rather than a distributive share of partnership income. The court found this argument to be merely rehashing YA Global's earlier arguments that the S.P.V.'s were not partners.

TAKEAWAY

The court's analysis is of somewhat limited relevance since this version of §704(e)(1) no longer is in effect. Nonetheless, it illustrates the difference in the type of inquiry when determining partner status under past law and current law. The reversion to only a subjective test makes planning more uncertain.

Under either test, the court was ultimately persuaded that the S.P.V.'s were partners of YA Globa based on YA Global's tax reporting and the absence of any contradictory evidence. Even under a subjective test, it can be difficult to defeat the objective facts.

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DEMOCRATS VS. REPUBLICANS: OPPOSITE VIEWS ON TAXES

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Tags
2024 Income Tax
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INTRODUCTION

Democrats and Republicans have starkly different views about a host of issues, including a number of social and foreign policy issues. The parties' positions on taxes are also diametrically opposed.

The party platforms are fairly straight forward and are reproduced in full:

Democrats (Party Platform)

> *Reforming the Tax Code to Benefit Working Families*
>
> Our tax system has been rigged against the American people by big corporations and their lobbyists, and by Republican politicians who dole out tax cuts to their biggest donors while leaving working families to struggle.
>
> Democrats will take action to reverse the Trump Administration's tax cuts benefiting the wealthiest Americans and rewarding corporations for shipping American jobs overseas. We will crack down on overseas tax havens and close loopholes that are exploited by the wealthiest Americans and biggest corporations. We will make sure the wealthy pay their fair share in taxes. We will make sure investors pay the same tax rates as workers and bring an end to expensive and unproductive tax loopholes, including the carried interest loophole. Corporate tax rates, which were cut sharply by the 2017 Republican tax cut, must be raised, and "trickle-down" tax cuts must be rejected. Estate taxes should also be raised back to the historical norm.
>
> Democrats will reform the tax code to be more progressive and equitable, and reduce barriers for working families to benefit from targeted tax breaks, including the Earned Income Tax Credit and the Child Tax Credit. Our program of reform will provide immediate, marked relief for working families, including more generous, refundable tax credits to benefit low- and middle-income families, and easier and more equitable access to tax provisions that help working families build wealth, including by equalizing tax benefits for retirement contributions and providing more accessible tax breaks for homeownership.

Republicans (Party Platform)

> *Make Trump Tax Cuts Permanent and No Tax on Tips*
>
> Republicans will make permanent the provisions of the Trump Tax Cuts and Jobs Act that doubled the standard deduction, expanded

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> the Child Tax Credit, and spurred Economic Growth for all Americans. We will eliminate Taxes on Tips for millions of Restaurant and Hospitality Workers, and pursue additional Tax Cuts.

Note that Donald Trump has announced that he would propose eliminating income taxes on Social Security benefits.

Harris' past proposals in 2019, when she was running to be the Democratic candidate, were different from Biden's proposals.[1] While Biden pledged not to raise taxes on anyone making less than $400,000. Harris' plans focused on a lower income threshold: $100,000. Harris would have repealed the Tax Cuts and Jobs Act with the exception of provisions benefiting taxpayers earning less than $100,000 per year (as reported in the publication *Tax Notes*). Other proposals included an increase in the corporate tax rate to 35% and increases to the estate tax rates. Harris's proposals today are more in line with the Biden proposals, with some significant changes. She has recently announced that she would eliminate tax on tip income, similar to the earlier Trump proposal.

This article will explore these differences and some possible tax law changes, depending on the composition of the Senate and House, as well as the Presidency. We will compare the tax proposals set forth in the "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals," which is commonly referred to as the "Green Book" (summarizing the proposals for the Biden Administration's Fiscal Year 2025 Budget) with the Republican "Mandate for Leadership, the Conservative Promise — Project 2025, Presidential Transition Project ("Project 2025") guide to tax policy. Harris' proposals (as they differ from the Biden proposals) will be noted, as well. Actual tax proposals in the future may not reflect these two position papers.

THE DEMOCRATS

The Democrats would raise the corporate rate to 28% and the minimum tax on billion-dollar corporations to 21%. Harris would allow new companies to deduct up to $50,000 in start-up expenses.

There would be a 25% mark-to-market minimum tax on the individuals with wealth of more than $100 million.

The net investment income tax ("N.I.I.T.") and additional Medicare tax rate would be increased to 5% for taxpayers with adjusted gross income in excess of $400,000. All pass-through business income of taxpayers with adjusted net income in excess of $400,000 would be subject either to the 3.8% NIIT or the Medicare tax (currently 3.8%) under the Self-Employment Contributions Act ("S.E.C.A.")

There would be no deduction for compensation over $1 million paid to corporate employees, excluding compensation paid to employees of S-corporations. An S-corporation is a corporation that elects to be a pass-through for income and loss purposes. It was a precursor to an L.L.C., but is not as malleable as an L.L.C. when it comes to restructurings.

[1] Tobias Salinger, "How Kamala Harris may shift the crucial tax debate in this year's election," Accounting Today, July 22, 2024.

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Further measures would be taken to discourage corporations from booking profits in low-tax jurisdictions, stopping corporate inversions to tax havens, and raising the tax rate on U.S. multinationals' foreign earnings from 10.5 percent to 21 percent.

The tax on stock buybacks would be increased to 4% from 1%.

The types of distributions taxed as dividends would be expanded.

Harris would increase the global intangible low-taxed income ("G.I.L.T.I.") tax rate from 10.5% to 21 percent, calculate the tax on a jurisdiction-by-jurisdiction basis, and revise related rules.

She would also repeal the reduced tax rate on foreign-derived intangible income ("F.D.I.I.").

Tax cuts for individuals made by the 2017 tax law would be repealed. The top rate of 39.6% would be restored.

Capital gains would be taxed as ordinary income for those with more than $1 million in income.

The benefit of favorable carried interest treatment for investment fund managers would be eliminated, and income arising from a carried interest would be taxed as ordinary income.

Harris proposed a 28% tax on long-term capital gains, or assets owned for more than one year, for households making more than $1 million annually.

The like-kind exchange rules for real estate would be limited to $500,000 a year ($1,000,000 a married couple).

Transfers of appreciated property by gift or on death would be treated as realization events, thereby subjecting realized gains to income tax. The estate tax would continue to apply as well.

Harris has made a number of campaign proposals that would reduce taxes on low- and middle-income households by (i) expanding the Child Tax Credit ("C.T.C."), (ii) expanding the Earned Income Tax Credit ("E.I.T.C.") by expanding the age range and by adjusting the credit structure to be more generous to childless workers, (iii) increasing premium subsidies for health insurance under the Affordable Care Act ("A.C.A.") by extending certain provisions that would otherwise expire, and (iv) providing an average $25,000 in down payment assistance to qualified first-time homebuyers:

Under current law, eligible families receive a tax credit of up to $2,000 per child, a portion of which is refundable ($1,700 in 2024). Starting in 2026, the total credit amount will decrease to $1,000. Under the Harris campaign policy proposal, the credit amount would instead permanently increase to $3,600 per child 5 years and younger, and to $3,000 per child older than 5 years starting in 2025. The proposal would also increase the maximum age of eligible children from 16 to 17 and make the credit fully refundable. Families with newborns would receive an additional $2,400 fully refundable credit during the first year of the child's life, bringing the total maximum credit value to $6,000 for newborn children.

Harris favors raising the corporate income tax rate to 28 percent. Under current law, corporations pay a statutory tax rate of 21 percent on their taxable income. This proposal would raise that rate to 28 percent. That would reverse one-half of the statutory corporate tax rate reduction that was enacted as part of the 2017 Tax Cuts and Jobs Act, which lowered the rate from 35 percent to 21 percent.

THE REPUBLICANS

The 2025 Proposal[2] would continue the combined payroll tax of 15.3%.

Income tax would be imposed at a 15% rate (after application of a standard deduction) up to the payroll tax cap, currently $168,600 and indexed for inflation, and at 30% for income above that amount.

Capital gains and qualified dividends would be indexed and taxed at a rate of 15%. Most deductions, credits, and exclusions, including the earned income tax credit, would be eliminated.

The corporate tax rate would be lowered to 18%.

The estate and gift tax rate would be lowered to a rate not higher than 20% and the temporary, higher exemption amount passed as part of the 2017 tax law would be made permanent.

The G.I.L.T.I. regime was one of the biggest changes from the T.C.J.A. G.I.L.T.I. tax is currently levied at an effective rate of 10.5%, which is scheduled to rise to 13.125%. The proposal would cap the tax rate at 12.5%. (In combination with the proposed reduced corporate rate of 18%, this would mean that the Code §250 deduction would be set at 69.44%.)

Many of the reforms in the Inflation Reduction Act of 2022, such as the corporate alternative minimum tax and the tax of stock buybacks, would be repealed.

Longer term proposals include the creation of a national sales tax, a business transfer tax, a cashflow tax, and a Hall-Rabushka flat tax. The proposal generally calls for the elimination of most deductions and credits but proposes new or expanded credits in areas such as private education, rural housing, and U.S.-based manufacturing.

"Major differences exist as to the proper levels of taxation and the proper objects of expenditures. The country is at a major tipping point."

TAKEAWAY

Before the turn of the millennium, Democrats and Republicans shared many of the same ideas as to taxation. Regarding expenditures, there was agreement that certain expenditures needed to be made. However, Democrats generally preferred to spend more and Republicans generally preferred to spend less.

In today's Washington, consensus is a dirty word. Major differences exist as to the proper levels of taxation and the proper objects of expenditures. The country is at a major tipping point.

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[2] See Sullivan, Martin, "Your Guide to Tax Policy in Project 2025", Tax Notes (8/14/2024) for a compete discussion.

About Us

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