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INSIGHTS

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EDITORS' NOTE

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

- **U.K. Requirement to Correct.** The "Requirement to Correct" ("R.T.C.") rules for offshore tax affairs in the U.K. threaten steep penalties if noncompliant taxpayers at April 5, 2017, do not take action to correct the relevant noncompliance by September 30, 2018. In a detailed look at the R.T.C. rules, Gary Ashford of Harbottle & Lewis L.L.P., London, explains the ins and outs of the provisions, including (i) the definition of offshore noncompliance, (ii) covered taxes, (iii) penalties, (iv) the reasonable cause defense, (v) disqualified advice that cannot be reasonable cause, (v) the method that must be followed to implement a valid correction, (vi) the statute of limitations, and (vi) recent guidance from H.M.R.C. regarding last minute notifications by noncompliant taxpayers. The final date for completing a correction is December 29, 2018.

- **Israeli Court Case First to Interpret Ten-Year Exemption.** Effective in 2007, Israel's New Immigrant Benefits rules are intended to promote immigration through the grant of substantial tax benefits: (i) a ten-year tax exemption for foreign-source income produced or accrued outside Israel or income stemming from assets located outside Israel and (ii) an exemption for all tax reporting requirements related to exempt income. Over the years, the Israeli tax authorities applied strict rules in determining (i) whether a specific item of income should be considered to be foreign source income and (ii) the portion that is properly treated as foreign in circumstances of mixed income – part foreign and part domestic. Now, eleven years after the New Immigrant Benefits rules became effective, the first case addressing these open questions has been decided, *Talmi v. Kfar Saba Tax Assessor*. Daniel Paserman and Inbar Barak-Bilu of Gorntizky & Co., Tel Aviv, report on the holding. In brief, the taxpayer won on principles but lost on the basis of his facts.

- **Coming to the U.S. After Tax Reform.** Now, more than six months after enactment of the Tax Cuts & Jobs Act, many tax advisers have achieved a level of comfort with the brave new world of Transition Tax, F.D.I.I., G.I.L.T.I., B.E.A.T., and incredibly low corporate tax rates. However, sleeper provisions in the new law can have drastic adverse tax consequences in the realm of cross-border transactions and investments: (i) the threshold for becoming a C.F.C. has been reduced significantly by several changes in U.S. tax law and (ii) the 10.5% tax rate for G.I.L.T.I. is limited to corporations so that individuals face ordinary income treatment for G.I.L.T.I. inclusions from foreign corporations that were not C.F.C's. prior to the new law. Jeanne Goulet of Byrum River Consulting L.L.C., New York, addresses these problems and suggests several planning opportunities.

- **Joint Audits: A New Tool to Combat Cross-Border Tax Evasion.** When a large corporate taxpayer receives an audit notification letter from the tax authority in its country of residence, the taxpayer typically knows what to expect: a lengthy process of documenting and defending its tax position. It also knows the process under domestic law for appealing adverse tax adjustments, and if cross-border issues are raised, it knows how to take advantage of Mutual Agreement Procedures between competent authorities under an income tax treaty. The full process can take years to resolve. Now, however, a pilot program between German and Italian tax authorities empowers a joint cross-border audit team to conduct a single joint audit of cross-border operations between the two countries. The joint audit is intended to be more effective for resolving issues of double taxation in cases involving complex facts related to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) aggressive tax planning schemes. Marco Orlandi of Ludovici Piccone & Partners, Milan, examines the actual process followed in the pilot program and comments on whether the goals of the joint audit have been achieved.

- **Inbound Acquisition Due Diligence Under U.S. Tax Reform.** M&A transactions have accelerated as the U.S. economy reacts to the adoption of favorable rules under the Tax Cuts & Jobs Act. But, as mentioned in "Coming to the U.S. After Tax Reform," an article by Jeanne Goulet in this edition of *Insights*, many adverse sleeper provisions have also been introduced. For those tax advisers assigned due diligence tasks in advance of an M&A transaction, several additional pages have been added to the D.D. Checklist. Elizabeth V. Zanet and Beate Erwin address the new exposure areas that must be identified by the D.D. team.

- **Blockchain 101.** Blockchain has been in the spotlight since early 2017, mostly due to the 2017 surge in cryptocurrency values and the rise of initial coin offerings. Many legal advisors have clients who use or wish to use blockchain in their businesses, and yet, the actual technology is often not discussed in the legal field. In a series of Q&A's, Fanny Karaman and Galia Antebi explain the rationale behind the technology and reasons for its reliability. Because blockchain is a decentralized system with inherent proof of work built into the program, it can eliminate the need for intermediaries, such as banks, lawyers, and brokers. Advisers should be aware of the benefits of the technology, as well as its potential for disrupting the legal landscape.

- **Have You Inherited a P.F.I.C.? – What it Means to Be a U.S. Beneficiary.** In today's global environment, it is not surprising to find that a beneficiary of a foreign estate or trust is living in the U.S. An interest in a foreign trust can be problematic for the beneficiary if the foreign trust invests through a foreign "blocker" corporation that holds passive assets (such as publicly traded stocks and securities) or a foreign mutual fund. These companies can stumble into P.F.I.C. categorization for U.S. tax purposes, which yields sub-optimal tax consequences for the U.S. beneficiary. Rusudan Shervashidze and Nina Krauthamer break down the U.S. tax rules that make a foreign corporation a P.F.I.C., the various ways a U.S. investor in a P.F.I.C. will be taxed, and the reporting obligations that are imposed on the U.S. investor in a P.F.I.C.

- **Updates and Other Tidbits.** This month, Neha Rastogi and Nina Krauthamer look at several interesting updates and tidbits, including (i) an I.R.S. notice that addresses legislative workarounds to limitations on deductions for state and local tax payments effective in 2018, (ii) new rules under Code §83(i), which allow a qualified employee to defer income attributable to stock received in connection with the exercise of an option or the settlement of a restricted stock unit ("R.S.U."), and (iii) a call for guidance regarding cryptocurrency accounting.

- The Editors

U.K. REQUIREMENT TO CORRECT

Author
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Tags
Tax Compliance
United Kingdom

BACKGROUND

The "Requirement to Correct" ("R.T.C.") rules became law when the Finance (No. 2) Act 2017 received Royal Assent on November 16, 2017. The legislation required taxpayers who were noncompliant as of April 5, 2017, with regard to offshore tax affairs, to correct the relevant noncompliance by September 30, 2018. The deadline corresponds to the final date for over 100 jurisdictions who have signed up to exchange data on financial accounts information. Under the Model for Automatic Exchange of Financial Account Information in Tax Matters (Common Reporting Standard ("C.R.S.")), H.M.R.C. will have more access to personal financial information about offshore assets held than ever before.

Under the initial legislation, failure to correct by September 30, 2018, would result in a 200% penalty being applied, plus a potential penalty of 10% of the value of the associated asset. Subsequent to government consultation, H.M.R.C. has published updated guidance, which includes a much-welcomed relaxation to the penalties where (i) ahead of the September 30, 2018, deadline, H.M.R.C. has been notified that a disclosure will be made, and (ii) the disclosure is made ahead of the associated deadline for the particular disclosure route taken. The final date is December 29, 2018. Given the significant liability, not to mention the scrutiny and administration costs, it is vital to review historic U.K. tax compliance in advance of this date.

Gary Ashford C.T.A. Fellow, A.T.T., is a partner (non-lawyer) at Harbottle and Lewis LLP. His practice focuses on high net worth individuals, especially regarding non-domiciled taxation. He is a member of the Chartered Institute of Taxation ("CIOT") and has participated in government consultation on their behalf.

WHAT IS OFFSHORE NONCOMPLIANCE?

The definition of offshore noncompliance is far-reaching and relates to *any* compliance matter where tax is owed to H.M.R.C. as a result of tax noncompliance where there is an offshore connection.

WHAT TAXES ARE COVERED?

The R.T.C. applies to any person with potential undisclosed U.K. income tax, capital gains tax, and/or inheritance tax liabilities.

"Persons" refers to the following:

- Individuals
- Partnerships
- Trustees
- Nonresident landlord individuals/companies

WHAT ARE THE PENALTIES?

The standard penalty is 200% of the tax liability but can be reduced according to factors such as cooperation and quality of the disclosure to H.M.R.C. However, the minimum penalty is 100% of the tax liability. Where, after the deadline, H.M.R.C. opens an enquiry ahead of any disclosure, the penalty cannot be less than 150%.

Where H.M.R.C. believes that the person was aware of the tax noncompliance and failed to correct by the deadline, they can apply an additional penalty to the standard penalty and seek up to 10% of the value of the assets linked to the offshore noncompliance.

There is also potentially a further penalty of 50% if it can be shown that assets were intentionally moved to avoid, for example, an overseas bank reporting the account to H.M.R.C.

In serious cases, which involve over £25,000 in tax any tax year, H.M.R.C. may cause reputational damage by publishing the taxpayer's details on a public website.

REASONABLE EXCUSE

Penalties will be chargeable for failure to correct, unless the taxpayer can demonstrate a "reasonable excuse" existed for not meeting the obligation. The definition of a "reasonable excuse" is very narrow. The legislation makes it clear that a reasonable excuse cannot be based on tax advice received from an "interested person." Such advice will not be accepted and will instead be treated as "disqualified" advice.

If the taxpayer fails to make a correction but has a reasonable excuse for not doing so, a penalty will not be imposed, and an obligation will exist to pay the tax owed and accompanying interest.

WHAT IS CONSIDERED "DISQUALIFIED ADVICE"?

- Advice given to the taxpayer by an interested person
- Advice given to the taxpayer as a result of arrangements made between an interested person and the person giving the advice
- Advice given by an advisor who does not have appropriate expertise in the matter
- Advice which does not consider all of the person's individual circumstances
- Advice that is addressed to, or is given to, a person other than the taxpayer

WHO IS AN INTERESTED PERSON?

An interested person is someone who has participated in the "avoidance arrangement or has received consideration for implementing or facilitating entry into a tax avoidance arrangement."

An interested person includes the following:

- A body of persons both corporate or unincorporated
- Limited companies
- Accounting firms
- Limited liability partnerships

H.M.R.C. guidance on the R.T.C. provides examples of disqualified advice.

Example 1

> *Trustees of an offshore trust obtain advice from an accountancy firm on how best to distribute funds to U.K. and non-U.K. beneficiaries. The firm specializes in giving this advice. After considering the trust and the beneficiaries' circumstances, the accountant advises the trustees on how to make distributions in a way that they minimize their tax position.*
>
> *Some years later, H.M.R.C. challenges the trustees and the beneficiaries for not paying enough tax on the distributions and for failure to correct.*

As the advice was given by an interested person (a firm of accountants) and concerned "avoidance arrangements," it is treated as disqualified advice and cannot be used as a reasonable excuse.

Example 2

> *The facts are the same as in Example 1, however, in this scenario, the trustees later undertook a secondary and independent review from a person with the appropriate expertise who was not involved in facilitating the original arrangements. Provided that the trustees followed the advice given and it took into account the trustees' and beneficiaries' circumstances, then it can be relied on as a reasonable excuse if the trustees fail to make a correction.*

"The legislation requires taxpayers who, as of April 5, 2017, are noncompliant with regards to their offshore tax affairs, to correct the relevant noncompliance by September 30, 2018."

The trustees in Example 1 sought advice in good faith. However, the R.T.C. legislation clearly seeks to disregard advice given by professional advisors paid to do so, and an independent review from a peer, as in Example 2, is necessary to ensure the advice is not considered as disqualified advice.

HOW CAN CORRECTIONS BE MADE?

A correction can be made by refiling tax documents (*e.g.*, a self-assessment tax return). Consideration should be given to using the Worldwide Disclosure Facility ("W.D.F.") or the Contractual Disclosure Facility ("C.D.F."). The latter should be used in cases where the noncompliance results from deliberate behavior.

For taxpayers who are not confident that their offshore affairs are tax complaint, a review should be carried out to assess their tax position by someone whose advice will not be disqualified, and then a disclosure should be made, if appropriate.

As stated above, it is important to take the initiative and file a disclosure, or notify H.M.R.C. of the intention to file, before September 30, 2018. If a tax enquiry is already underway, the disclosure must be made within 60 days. If using the W.D.F., the disclosure should be made within 90 days. If using the C.D.F., the disclosure should be made within 60 days (i.e., the Outline Disclosure deadline).

If there are concerns that H.M.R.C. could successfully dispute a historical tax position, it may be prudent to lodge a "protective" disclosure regarding the potential noncompliance.

WHAT IS THE STATUTE OF LIMITATIONS?

Under "normal" tax rules, H.M.R.C. has the following time limits to make an assessment:

- Four years in circumstances of reasonable care
- Six years in circumstances of careless behavior
- 20 years in circumstances of deliberate behavior

For the purposes of R.T.C., however, the "normal" H.M.R.C. time limits have been extended retroactively by four years. This means that up until April 5, 2021, a person who has failed to correct can still be investigated by H.M.R.C. as follows:

- For assessments not involving careless or deliberate behavior,
- H.M.R.C. can still go back to 2013-14.
- For assessments including careless behavior, H.M.R.C. can still go back
- to 2011-12.
- For assessments involving deliberate behavior, H.M.R.C. can still go back to 1997-98.

WHAT STEPS CAN TAXPAYERS TAKE?

Given the scale of R.T.C. penalties, doing nothing is no longer a viable option where a history of noncompliance exists. A number of options can be taken to regularize the taxpayer's position and avoid penalties, depending on the exact circumstances.

Counsel can assist in analyzing the taxpayer's position and recommend the most appropriate course of action, by taking the following steps:

- Review the historic tax position.
- Perform a tax health check.
- Review any existing advice from previous advisors.
- Where appropriate, assist in making a disclosure to H.M.R.C. or correcting offshore noncompliance.

ISRAELI COURT CASE FIRST TO INTERPRET TEN-YEAR EXEMPTION

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New Immigrant Benefits
Non-Domiciled Taxation

Nearly a decade after its enactment, *Talmi v. Kfar Saba Tax Assessor* is the first court case to address the implementation and interpretation of the special residents tax regime for new Israeli residents and veteran returning residents ("New Immigrant Benefits").

BACKGROUND

In honor of its 60th Independence Day in 2008, Israel introduced a special tax regime intended for new Israeli residents and veteran returning residents, beginning as of 2007. The New Immigrant Benefits are intended to encourage diaspora Jews and former Israelis to move to Israel by providing them with substantial tax benefits. Pursuant to the amendment, the tax benefits grant a ten-year tax exemption on foreign-source income produced or accrued outside Israel and income stemming from assets located outside Israel. The New Immigrant Benefits also grant an exemption from any tax reporting requirements with respect to foreign income and assets – meaning that new Israeli residents or veteran returning residents are liable to tax and reporting in Israel during the ten-year period only with respect to income derived from an Israeli source or an asset located in Israeli.

THE TALMI CASE – TAXATION OF NEW AND RETURNING RESIDENTS

In the *Talmi* case, an individual returned to Israel after residing in the U.K. for a period of 20 years. He was employed in the U.K. by E.M.C. (the "Company") from 1994 and continued to be employed by the Company after his return to Israel in 2007. His position after his return was Sales Area Finance Manager for the area consisting of Israel, Turkey, Greece, Cyprus, and Malta.

Three points of controversy arose between the Israeli Tax Authority and the individual:

- The individual claimed that income he received from the Company upon his return to Israel was derived in connection with assets he developed for the Company during the time he resided outside Israel as a U.K. resident. Thus, he contended, the income was foreign income that should not be taxed in Israel during the ten-year exemption period.
- The individual also claimed that the source of the income should be determined by reference to the underlying sales of the Company in each country within the region and not as asserted by the Tax Assessor on the number of days of presence in each location. The basis for his argument was that he was compensated by reference to sales volume and not time spent.

Adv. Daniel Paserman (CPA), TEP is head of tax at Gornitzky & Co. and secretary of the Society of Trust and Estate Practitioners ("STEP") Israel. He is involved in corporate international tax planning and tax litigation. He also advises new immigrants and returning residents to Israel on taxation and tax exemption issues concerning their global assets and business activities.

Adv. Inbar Barak-Bilu (CPA), TEP is an associate at Gornitzky. She advises corporate and private clients on a wide range of taxation issues, including tax planning, private wealth, and trusts.

- Finally, he claimed that the date of his return to Israel was July 1, 2007, when his assignment commenced. The Tax Assessor, however, claimed he returned to Israel on January 1, 2007, which was the first day of the year in which the individual began spending more days in Israel than abroad.

In brief, the court ruled on each of the issues as follows.

- **Income Derived from Assets** – The exemption should be interpreted in a broad sense. If the income being paid bears a substantial connection to foreign assets developed prior to the date on which the individual first became an Israeli tax resident, the income was accrued from a foreign asset.

  The court looked to the legislative intent behind the enactment of the New Immigrant Benefits program. It was designed to encourage the return of individuals. It accomplished this in part by granting an exemption for income accrued outside of Israel. According to the court, the term "assets" should be broadly interpreted. Consequently, work methods, sale methods, financial products, various mechanisms, and so forth developed by an individual during the period of absence from Israel should be considered "foreign assets" when applying the exemption. Having said that, the court determined that the individual failed to prove existence of such assets.

"The tax benefits grant a ten-year tax exemption on foreign-source income produced or accrued outside Israel and income stemming from assets located outside Israel."

- **Income Derived from Employment** – The court rules that income should be allocated based on the actual location in which a service was provided. In the absence of any other evidence on the individual's part, adopting the formula set in the 2011 Income Tax Circular, according to which the allocation should be based on the business days spent by the individual in Israel and abroad, is reasonable and acceptable.
- **Date of Commencement of Residency** – The court disagreed with the position of the Tax Assessor. The process of relocating the center of vital interests ("Center of Life") of an individual to a different country does not take place abruptly. Rather, it is a gradual process, maturing over a given period of time. This is relevant to both the commencement and the termination of fiscal residency. When examining the individual's physical presence for each day in 2007, the individual spent only half his time in Israel from January 1 through May 31. However, he spent most of his time in Israel beginning at a certain point in June. In addition, his employment contract began on July 1, 2007. Consequently, the court ruled that the individual's date of return to Israel was July 1, 2007.

CONCLUSION

The New Immigrant Benefits have been in place for nearly a decade, and the ruling in the *Talmi* case is the first to discuss the regime and its interpretation. The court has taken a broad stance, which aims to maintain the original intention of the legislation. Undoubtedly, this is good news for individuals wishing to benefit from the provisions of this tax regime. However, it was a sad day for the taxpayer involved in the case. In sum, the Tax Assessor won regarding this particular taxpayer but may have lost on the issue of broader application, the starting date of residence.

COMING TO THE U.S. AFTER TAX REFORM[1]

Author
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Tags
C.F.C.
Foreign Investment
Holding Company
T.C.J.A.
U.S. Shareholder

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INTRODUCTION

Non-U.S. emerging companies continue to migrate to the U.S. to seek venture capital funding. Many founders and their attorneys have asked if the 2017 Tax Cuts and Jobs Act ("T.C.J.A.") contains changes to the tax provisions that will affect the fundamental investment structure often used prior to its enactment. The answer to that question is dependent on the particular needs and priorities of each business or investor.

Given the time that has passed since the date of enactment of the T.C.J.A., the time for broad explanations is over. Instead, this article briefly mentions the obvious changes to the law and proceeds to focus on several "sleeper provisions" that have been the domain of "elite" international tax advisors. These provisions can be quite troublesome for those who do not devote hours each day to the intricacies of tax law after the T.C.J.A. As explained below in detail, the incidence of tax for U.S. persons that own foreign enterprises has expanded exponentially. The trip wires for taxation under Subpart F have multiplied. Even if tax exposure under Subpart F can be managed, the reward is not deferral. Rather, it is immediate tax under the global intangible low-taxed income ("G.I.L.T.I.") provisions. This may be fine for corporations because tax under the G.I.L.T.I. regime is low. But it may generate highly taxed income for individual U.S. Shareholders.

OVERVIEW OF THE T.C.J.A.

Obvious changes brought about by the T.C.J.A. are well known:

- A reduction of the corporate tax rate to 21%
- An elimination of Net Operating Loss ("N.O.L.") carrybacks and limit on the N.O.L. benefit to 80% of taxable income in the carryover year[2]
- A repeal of the U.S. deferral system on foreign earnings in favor of a quasi-territorial system that taxes G.I.L.T.I. of a Controlled Foreign Corporation ("C.F.C.") on a current basis
- The adoption of a dividends received deduction for U.S. corporations receiving dividends from 10%-owned subsidiaries, along with a catch-up transition tax in 2017 that purges C.F.C.'s and other foreign corporations ("F.C.'s") that are at least 10%-owned by one or more U.S. corporations

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1 The author wishes to thank Stanley C. Ruchelman for his review of this article.

2 Thus, 20% of taxable income is taxed at 21% and the balance is carried forward indefinitely.

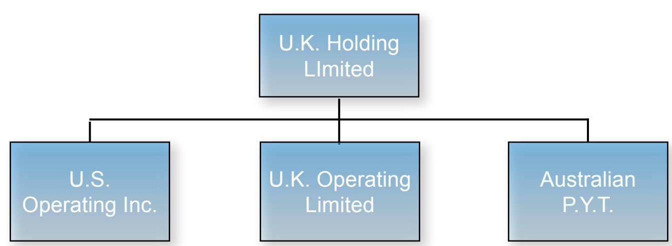
- An imposition of a minimum tax on base erosion and anti-abuse tax ("B.E.A.T.") payments to related parties outside the U.S. in the context of large multinational groups
- A preferential tax regime for foreign derived intangible income ("F.D.I.I.") of U.S. corporate taxpayers
- A restriction on the deductibility of business interest expense
- More favorable expensing provisions for asset acquisitions
- Special deductions for individuals who own pass-thru entities in certain business sectors
- A repeal of the corporate alternative minimum tax

SLEEPER PROVISIONS

Beginning in 2018, non-U.S. founders of non-U.S. businesses must navigate the sleeper provisions of the T.C.J.A. and their potential impact on F.C.'s and their U.S. investors. Founders and executives of certain F.C.'s will need to provide some of their U.S. investors with financial information so that they can meet their U.S. tax compliance requirements. In addition, the U.S. subsidiary of the F.C. may have incremental U.S. tax filings, which will provide detailed financial information regarding certain foreign affiliates owned in part by members of the foreign group and in part by others. Non-U.S. entrepreneurs looking to expand into the U.S. will need to acquire a basic understanding of the U.S. tax laws that will affect their global business and their U.S. investors.

TYPICAL F.C. HOLDING STRUCTURE

Generally, a non-U.S. startup that has successfully created a new scalable business at home will be encouraged to expand to the U.S. in order to intensify growth. A common structure employed is the following:



Under prior law, investors in U.K. Holding Limited ("U.K.H.L.") could potentially be either non-U.S. investors or U.S. investors, which can be further divided in two groups. Group 1 consists of U.S. investors who own shares representing less than 10% of the voting power of U.K.H.L. Group 2 includes U.S. investors who own shares representing 10% or more of the voting power of U.K.H.L. (commonly referred to as "U.S. Shareholders").

If Group 2 owns more than 50% of the shares, U.K.H.L. would be a C.F.C. for U.S. tax purposes. A C.F.C. today is subject to the anti-deferral rules of Subpart F and the new G.I.L.T.I. provisions (to be defined later), thus leading to current income for the U.S. Shareholders in Group 2, even if no cash distributions are received from U.K.H.L.

NEW U.S. SHAREHOLDER DEFINITION

The T.C.J.A. expands upon the circumstances in which an F.C. may be considered to be a C.F.C. by modifying the standard for an investor to be considered a U.S. Shareholder. As a result, the term U.S. Shareholder has been expanded to include an investor that owns shares representing 10% or more of the total value of shares of an F.C. Prior law looked only to the ownership of shares representing 10% or more of the total voting power of an F.C.[3]

While founders typically own voting stock, many venture capital funds may own "preferred shares" with no voting power but substantial value. For example, a venture capital fund may have invested all or most of its equity with a right of repayment that is senior to the rights of the common shares. In the past, a U.S. venture capital fund that holds only preferred shares with no voting power was not considered to be a U.S. Shareholder. Consequently, U.S. holders of non-voting preferred shares were not U.S. Shareholders for purposes of determining whether an F.C. were a C.F.C.

With the new expanded definition, that type of U.S. investor can be considered a U.S. Shareholder under the value-based test. Consequently, more F.C.'s will be C.F.C.'s, and more U.S. investors will be subject to the Subpart F regime and the G.I.L.T.I. provisions.

NEW DEFINITION OF C.F.C.

A C.F.C. is generally defined as any F.C. in which more than 50% of the total combined voting power of all classes of stock or of the total value of the stock is considered to be directly, indirectly, or constructively owned by U.S. Shareholders on any day of the taxable year.[4]

<u>Constructive Ownership in an F.C.</u>

In determining U.S. Shareholder and C.F.C. statuses, shares of stock owned directly, indirectly, and constructively in an F.C. are taken into account.[5] In contrast, only direct and indirect ownership — not constructive ownership — are taken into account in determining whether a U.S. Shareholder is required to include Subpart F Income in gross income and the amount to be included.[6]

The constructive ownership rules apply for purposes of determining whether (i) a U.S. person is a U.S. Shareholder; (ii) an F.C. is a C.F.C.; (iii) the stock of a domestic corporation is owned by a U.S. Shareholder of a C.F.C. for purposes of the rules taxing U.S. Shareholders when a C.F.C. makes a taxable investment in U.S. property; and (iv) a corporation or other person is related to the C.F.C. While the constructive ownership rules do not apply for purposes of determining the amount of gross income included in a U.S. Shareholder's income, they can cause actual U.S.

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[3] Code §951(b).

[4] Code §957.

[5] Code §§958(a)–(b).

[6] Code §951(a).

Shareholders of an F.C. that is not a C.F.C. to be taxed on a current basis under Subpart F income rules and G.I.L.T.I. rules.

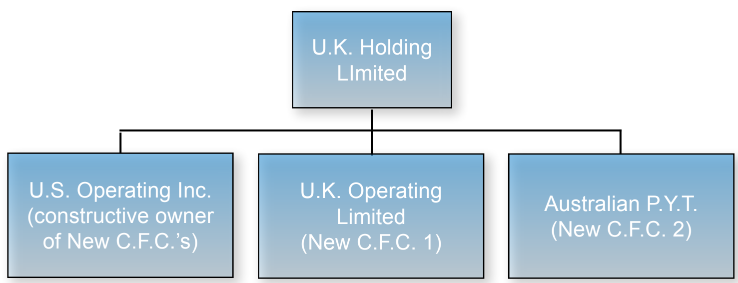
Loophole in Prior Law

Under prior law, a loophole existed that allowed tax deferred earnings of a C.F.C. to escape the U.S. tax regime when a U.S.-based group owning the C.F.C. inverted into a foreign-based group and the foreign parent acquired newly issued shares in the C.F.C. Prior law prevented ownership of the newly issued shares in the C.F.C. from being attributed to members of the U.S. group. As a result, in the right fact pattern, the C.F.C. could become an F.C. and dividends could be distributed to the foreign parent and loans could be made to U.S. affiliates without having to worry about taxation in the U.S. under Subpar F. Congress closed the loophole with the T.C.J.A., by eliminating the rule[7] that prevented the "downward" constructive attribution of stock owned by non-U.S. persons to a U.S. person.[8]

Example

For example, U.K. Operating Limited and Australian P.T.Y. are owned by a foreign parent, U.K.H.L. They can be attributed constructively to its U.S. subsidiary, U.S. Operating Inc. The repeal of the downward attribution rule leads to a surprising outcome where an innocent bystander, the U.S. Shareholder, is taxed.

In the diagram below, because U.K.H.L. owns 50% or more of U.S. Operating Inc., U.S. Operating Inc. takes the place of its parent, U.K.H.L., and is deemed to own the shares that U.K.H.L. owns in U.K. Operating Limited and Australian P.T.Y. As a result, the two latter F.C.'s become C.F.C.'s, which for purposes of this discussion we shall name as "New C.F.C.'s."



Initial Phase

If a U.S. person does not directly or indirectly own shares in U.K.H.L. representing 10% or more of the voting power or value of U.K.H.L., no income inclusion is mandated for U.S. Operating Inc. under Subpart F or the G.I.L.T.I. regime. However, there is a possibility that U.S. Operating Inc. would be required to file information returns on each of the New C.F.C.'s, although some language in the legislative history indicates that a comparable change was not made in the information reporting rules in Code §6038.[9] In any event, I.R.S. guidance issued in Notice 2018-13 waives the requirement for filing information returns where there are no direct or indirect U.S. Shareholders in the New C.F.C.'s.

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7 Code §958(b)(4).

8 Code §318(a)(3).

9 See the discussion of the Senate Amendment in the Conference Committee Report to PL 115-97, 12/22/2017, at note 1529.

Subsequent Phase

Over time, the company grows and raises new capital from U.S. investors. If one or more investors in U.K.H.L. owns sufficient shares to be considered a U.S. Shareholder of U.K.H.L. and the New C.F.C.'s, U.S. Operating Inc. (as the constructive owner of its foreign affiliates) must file information returns regarding the New C.F.C.'s. No information return is required with regard to U.K.H.L. because U.S. Operating Inc. is not a constructive owner of U.K.H.L. Failure to file these returns carries a $10,000 penalty for each C.F.C. for each year in which a compliance failure occurs.

In addition, the U.S. Shareholders of U.K.H.L., as indirect U.S. Shareholders of the New C.F.C.'s, must include in current income any Subpart F Income and G.I.L.T.I. of the New C.F.C.'s.

Many international tax experts believe that the repeal of the downward attribution rule with respect to foreign parent companies has resulted in unintended consequences far beyond the loophole that concerned Congress. According to the Senate Finance Committee's explanation in the Senate bill, Congress intended for downward attribution to not apply in order for an F.C. to be treated as a C.F.C. with respect to a U.S. Shareholder not related[10] to the U.S. person (*e.g.*, U.S. Operating Inc.) to whom ownership of the F.C.'s stock was attributed.[11]

"The repeal of the downward attribution rule with respect to foreign parent companies has resulted in unintended consequences."

A technical amendment was proposed but was rejected as unnecessary. Now, there is a question as to whether the U.S. Treasury has the "authority" to create regulations limiting the application of this rule or whether taxpayers will have to wait for new legislation in a technical corrections bill.

EXECUTIVE RESPONSIBILITIES AND RESOURCES

U.S. Shareholders will be dependent on the financial management team of a C.F.C. to provide financial information that is needed to meet U.S. tax compliance obligations. In some countries, providing the necessary information regarding the identities of other shareholders may be prohibited. Even where not prohibited, financial management may be unwilling to provide information on a timely basis, if at all.

In these situations, the information gathering process must start well before the year end of the new C.F.C. The goal is to achieve congruence between the obligations of U.S. tax law and the agenda for financial management of the new C.F.C. It is critical for financial management to have a basic understanding of the fundamental concepts of Code §6038 in order to comply with these requests.

People with specific expertise will need to be assigned (*e.g.*, I.T. assistance for data accumulation programming) and additional funding will be required for the C.F.C. to perform these tasks on behalf of its U.S. Shareholders. An example of some of the information required is described in the definitions below.

REMAINING & NEW ANTI-DEFERRAL MEASURES

One of the major changes to the U.S. tax system is the move to a quasi-territorial

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10 Code §954(d)(3).

11 New York State Bar Association, Report on Section 965, no. 1388 (February 6, 2018), pp. 39–41.

system where dividends of C.F.C.'s are subject to a participation exemption and are not subject to tax when repatriated. Some substantial vestiges of the prior law remain to tax current U.S. Shareholders of C.F.C.'s.

Two continuing anti-deferral regimes and one new regime apply to 2018 and future years: Subpart F Income, investment in U.S. Property, and G.I.L.T.I. The most relevant concepts are briefly defined below.[12]

Subpart F Income

Despite the implementation of the T.C.J.A., the Subpart F rules remain in effect, and as the foregoing discussion indicates, are given broader scope. Subpart F Income includes foreign base company sales income, foreign base company services income, and foreign personal holding company income.[13]

- Foreign base company sales income is income derived in connection with the purchase of personal property from a related person and its sale to any person[14] whether in the form of profits, commissions, fees, or otherwise. Exceptions exist, *inter alia*, regarding sales of a product manufactured in the country of organization of a C.F.C. and sales of a product for use and consumption in the country of organization of a C.F.C.

- Foreign base company services income is income derived from performing services for, or on behalf of, a related person where the services are performed outside the C.F.C.'s country of organization.[15]

- Branches can be treated as separate companies when a sale to a branch yields the same tax effect overseas as a sale to a related person because of the disparity in tax rates between the branch and the home office.

- Subpart F is calculated on a C.F.C.-by-C.F.C. basis and an indirect foreign tax credit is available to offset some or all of the U.S. tax on such income.[16]

- The income inclusion under Subpart F is based on a concept of "earnings and profits," although the income inclusion is not treated as a deemed dividend.

The way in which Subpart F can apply to a software company will depend on the software product that will be marketed. If the software is developed by New C.F.C. 1 in the U.K. and sold as a shrink-wrap product to New C.F.C. 2 for distribution in Australia, no Subpart F Income arises in either country because the software is considered to be a copyrighted article. Because the article is "produced" in the U.K., New C.F.C. 1 does not have foreign base company sales income. The same result exists for New C.F.C. 2 in Australia because the article is sold for consumption and use in Australia.

If, on the other hand, the software is used as a service in an "SaaS" transaction, the key issue becomes foreign base company services income for services performed outside Australia by New C.F.C. 2.

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12 A detailed discussion of the three regimes is beyond the scope of this article.

13 Code §954(a).

14 Code §954(d)(1).

15 Code §954(e).

16 Code §§901–960.

Investment in U.S. Property

The investment in U.S. property[17] provisions continue to apply as an additional mechanism to generate current income tax for a U.S. Shareholder of a C.F.C., but only to the extent the U.S. Shareholder has not previously included the earnings for the year as Subpart F Income.[18] Once earnings are included in income, the investment in U.S. property is treated as previously taxed income ("P.T.I.") that is not taxed a second time.

Generally, an investment in U.S. property eliminates sovereign risk and for that reason in treated as a form of repatriation of earnings that is taxed to a U.S. Shareholder.

The definition of taxable U.S. property includes

- tangible property located in the U.S.,
- stock of a domestic corporation that is related,
- an obligation of a U.S. person that is related, or
- any right to use in the U.S. a copyright, patent, invention, model, design, formula, process, or similar property right the C.F.C. acquired or developed for use in the U.S.

G.I.L.T.I.

The G.I.L.T.I. regime[19] applies to U.S. Shareholders of C.F.C.'s. G.I.L.T.I. applies only to income that is not already taxed in the U.S. either at the level of a C.F.C. or its U.S. Shareholders. Consequently, the first step in computing G.I.L.T.I. is to eliminate the items of C.F.C. income that produce current tax. These include the following items of income:

- Business income that is subject to net-basis taxation in the U.S.
- Dividends from a related C.F.C. that are not subject to tax in the U.S. at either the level of the C.F.C. or the level of its U.S. Shareholders because of Subpart F
- All other C.F.C. income that results in an immediate U.S. tax under Subpart F for its U.S. Shareholders

"The obligation to recognize income on an accelerated current basis for an investment in a C.F.C. rather than an F.C. reduces the return on investment."

The remaining income is referred to as "Tested Income."

In determining how much Tested Income is treated as G.I.L.T.I., actual economic drivers for generating income are ignored. Instead, all items of C.F.C. income are deemed to arise from either depreciable tangible property or intangible property used in the business. Inventory, work in progress, or supplies are excluded in the computation. If the C.F.C. is a foreign bank, the financial assets of the bank also are ignored.

The investment in tangible depreciable property is deemed to generate a 10% yield

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[17] Code §§956 and 951(a)(1)(B).

[18] Code §959(a)(2).

[19] Code §951A.

computed with reference to the adjusted basis of the property. That is reduced by interest expense allocated against the tangible depreciable property. The balance of the income is attributable to intangible property, which in turn gives rise to G.I.L.T.I.

For U.S. corporations, a 50% deduction is available for domestic shareholders to produce a U.S. tax imposed at the rate of 10.5%.[20] An indirect foreign tax credit can be claimed against G.I.L.T.I. but only to the extent the foreign taxes relate to the net tested income that generates G.I.L.T.I.[21] The Code §78 gross up of foreign taxes into income applies. Of the foreign income taxes that relate to G.I.L.T.I., only 80% are creditable.[22] In addition, no carryover of unused taxes is permitted.[23] As a result, to the extent foreign income taxes are not utilized as a credit in the year they arise, no benefit is obtained. When dividends are distributed, they are considered to be P.T.I. and are not taxed again.[24]

TAX COSTS FOR U.S. INVESTORS

For European companies hoping to drive down the Technology Silk Road, from London to New York to Silicon Valley, the broader definitions of a U.S. Shareholder and the expansion of the stock attribution rules will result in many more F.C.'s being viewed to be C.F.C.'s. Significant compliance and U.S. income tax costs could serve as a deterrent to marginal investments. For the F.C., the duty to provide more information for the U.S. investor adds to the cost of raising funds in the U.S. For the U.S. Shareholder, the obligation to recognize income on an accelerated current basis for an investment in a C.F.C. rather than an F.C. reduces the return on investment.

Table A illustrates the tax cost for an individual investor in an F.C. compared to the tax cost that would occur if the F.C. becomes a C.F.C. The table assumes that the F.C. is a tech company with intellectual property ("I.P.") but no tangible depreciable property, which causes the U.S. investor to be taxed under the G.I.L.T.I. provisions. In addition, the calculations assume that the F.C. would pay a dividend in year two, which would be considered a qualified dividend.

TABLE A

	U.S. Shareholder Holds Shares of a C.F.C., No Code §962 Election	U.S. Shareholder Holds Shares of a Non-C.F.C.
Non-U.S. Income	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**

20 Code §250(a)(3)(b).

21 Code §960(d)(1).

22 *Id.*

23 Code §904(c).

24 Code §951A(f)(1).

TABLE A		
	U.S. Shareholder Holds Shares of a C.F.C., No Code §962 Election	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
G.I.L.T.I.		
Income	$82.00	–
Gross-up	$0.00	–
50% Deduction	–	–
Tax Rate	37%	–
U.S. G.I.L.T.I. Tax	$30.34	–
Worldwide Tax, Year 1	**$48.34**	**$18.00**
Dividend to Shareholder	$82.00	$82.00
P.T.I., Code §959	-$82.00	$0.00
Net Dividend	$0.00	$82.00
***Dividend Tax to Individual**	**$3.12**	**$19.52**
Worldwide Tax, Years 1 & 2	$51.46	$37.52
Worldwide Effective Tax Rate	**51.5%**	**37.5%**
Net Earnings After Tax, Years 1 & 2	***$48.54***	***$62.48***
*The net investment tax applies to the dividend.		

C.F.C.

In year one, a C.F.C. has earnings of $100, which is considered to be G.I.L.T.I., and a local tax rate of 18%, generating $82 net after tax. The U.S. Shareholder would be taxable in year one at the rate of 37% of $82, resulting in a tax of $30.34 with no cash distributed to the U.S. Shareholder. The worldwide tax in year one would be $48.34 (*i.e.*, $18.00 + $30.34).

In year two, when an $82 dividend is paid, it is not taxable as it is considered to be P.T.I.; however, there is a 3.8% net investment tax on the distribution. The resulting two-year U.S. tax is $33.46, and the worldwide tax is $51.46. Assuming a constant flow of G.I.L.T.I., the investor has an inclusion in the second year that matches the inclusion in the first year.

Non-C.F.C.

On the other hand, an investor in an F.C. that is not a C.F.C. is not subject to the G.I.L.T.I. provisions. The F.C. makes no cash distribution in year one. The worldwide tax in year one is, therefore, the local tax of $18.

In year two, when a distribution is made, the U.S. Shareholder pays a tax on qualified dividends and net investment tax of 23.8% for a total of $19.52. The total U.S. tax is $19.52, and the worldwide tax is $37.52.

As the table shows, if the F.C. is a C.F.C., the worldwide effective tax rate is 51.5%, whereas if the F.C. is not a C.F.C. the effective tax rate would be 37.5% – a 37% increase in tax results from the expansion of the C.F.C. definition.

Note that tax calculations will vary with differences in facts and assumptions, tax rates in the state of residence of the U.S. investor, and the applicable effective tax rate in the foreign country.

Mitigating Factors

When considering the practical application of these rules, the results may not be quite so onerous.

If no U.S. Shareholder exists, the issues above are merely theoretical. On the other hand, if a U.S. Shareholder does exist, the main foreign operating company that owns the I.P. may be operating at a loss. Until earnings are generated, neither Subpart F nor investment in U.S. property issues will apply. Similarly, in early years, G.I.L.T.I. inclusions are not likely to exist in light of typical revenue streams in this sector. Further, such companies rarely pay dividends but hope to have an exit, via a sale of shares.

"Individuals can make a technical election under Code §962 to be taxed as a corporation with regard to income taxed under G.I.L.T.I., investment in U.S. property, and Subpart F provisions."

POTENTIAL PLANNING OPPORTUNITIES

The "Delaware Flip"

One frequently discussed solution is to flip the F.C. group under a new U.S. parent ("Topco").

In some cases, moving foreign entities or assets under a U.S. Topco could result in foreign taxes (if unrealized gains exist) or trigger clawbacks of previously granted tax incentives. If a U.S. subsidiary exists as part of an F.C. group, it would need to be distributed out from under the foreign parent company in order to avoid the creation of a "U.S. Sandwich," which could result in potential income inclusions as "investments in U.S. property." Additionally, this distribution could be subject to taxes in the local country.

Of course, a Delaware Flip makes all remaining F.C.'s to C.F.C.'s but may provide savings under the foreign derived income rules if development activity occurs in the U.S.

The Code §962 Election

In spite of the challenges created by the T.C.J.A., planning opportunities can be employed by a U.S. Shareholder to mitigate potential U.S. taxes. For example, individuals can make a technical election under Code §962 to be taxed as a corporation with regard to income taxed under G.I.L.T.I., investment in U.S. property, and Subpart F provisions.

Code §962 was enacted as part of the original Subpart F regime with an intent to allow individuals who had invested in C.F.C.'s to have the same treatment they would have had if they invested through a U.S. corporation. The principal benefit is the deemed paid foreign tax credit allowed under Code §960. However, the election takes place annually and is often not perfect.

There are three major issues that limit the potential benefits of the election and appear to deviate from the original legislative intent:[25]

- First, if earnings of a C.F.C. are included in the income tax return of a U.S. individual under Subpart F, G.I.L.T.I., or investment in U.S. property provisions without an accompanying cash distribution, an actual dividend paid in a later year is considered to be P.T.I. and is normally not taxed again. In comparison, when an election is made by an individual under Code §962, the actual dividend from the foreign corporation is taxed a second time to the extent it exceeds taxes previously paid on the Subpart F inclusion.

- Second, the tax rate on the deemed dividend is a point of controversy with the I.R.S. The issue is whether the distribution should be treated as a qualified dividend[26] taxed at a rate that does not exceed 20%. The I.R.S. contends that the tax rate should be 37%.[27] Whichever rate applies, the net investment tax of 3.8% must be taken into account. There is currently a case in the Tax Court, *Smith v. Commr.*, addressing this matter. A request for summary judgment has been filed, and the matter may be resolved without a trial as the government's position seems weak in light of the Congressional purpose of a Code §962, which was to put an individual in the same place as having formed a U.S. corporation to act as the shareholder.

- Third, under the T.C.J.A., a 50% dividend received deduction is available to reduce the G.I.L.T.I. inclusion. This dividend received deduction is available to domestic corporations. The law does not state that it is available to individuals; although, given the purpose of the Code §962 election, one would expect that this benefit should be available.

Because of the current uncertainty regarding the calculation of the corporate tax under Code §962 alternatives, U.S. Shareholders should be cautious and evaluate the matter carefully before proceeding. Table B shows various results depending on which of these three issues are resolved in favor of the individual taxpayer.

TABLE B

	Result of Code §962 Election		
	Worst Case	**Mid Case**	**Best Case**
Non-U.S. Income	$100.00	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**	**$82.00**

25 S. Rep't No. 1881, 87th Cong., 2d Sess. 92 (1962).

26 Code §1(h)(11)(C).

27 *Smith v. Commr.*, No. 14900-15.

TABLE B			
	Result of Code §962 Election		
	Worst Case	**Mid Case**	**Best Case**
G.I.L.T.I.			
Income	$82.00	$82.00	$82.00
Gross-up	$18.00	$18.00	$18.00
50% Deduction	–	$50.00	$50.00
Tax Rate	21%	21%	21%
U.S. G.I.L.T.I. Tax	$21.00	$10.50	$10.50
F.T.C. (80% G.I.L.T.I. limitation)	-$14.00	-$14.00	-$14.00
F.T.C. Carryover	$0.00	$0.00	$0.00
U.S. Incremental Tax, Code §962(d)	$6.60	$0.00	$0.00
Worldwide Tax, Year 1	**$24.60**	**$18.00**	**$18.00**
Dividend to Shareholder	$82.00	$82.00	$82.00
P.T.I., Code §962(d)	-$6.60	$0.00	$0.00
Net Dividend	$75.40	$82.00	$82.00
Dividend Tax to individual	**$30.76**	**$29.17**	**$17.02**
Worldwide Tax, Years 1 & 2	$55.36	$47.17	$35.02
Worldwide Effective Tax Rate	**55.4%**	**47.2%**	**35%**
Net Earnings After Tax, Years 1 & 2	***$44.64***	***$52.83***	***$64.98***

In the "Worst Case," the absence of the 50% dividend received deduction results in a 21% tax rate. Thus, 80% of the $18 foreign tax is available as a $14.40 credit, leaving an incremental U.S. tax of $6.60 (*i.e.*, $21 - $14.40). The resulting worldwide tax in year one is $24.60. In year two, when a dividend is distributed to the individual, only $6.60 is allowed as P.T.I. or simply as a reduction to earnings and profits, leaving a total taxable income of $75.40. As the 20% qualifying dividend rate is not available, the dividend could be taxed at the 37% rate plus 3.8% net investment tax for a total tax of $30.76. The worldwide tax for year one and two is therefore $55.36. Certainly, selecting this alternative for a dividend-paying entity is not a good idea as the price of not making an election is only $51.46, as seen in Table A.

If some issues are resolved in favor of the individual taxpayer, the tax result could be more favorable. In the "Mid Case" calculation in Table B, the taxpayer would be entitled to a 50% dividend received deduction resulting in $10.50 of U.S. tax, which could be offset by an 80% foreign tax credit of $14.40. The additional $3.60 of excess foreign tax credit is lost because a carryover is not available, and the excess credit cannot be used against other foreign-source income. Therefore, the worldwide tax for year one is $18. In year two, when a dividend is distributed, only $10.50 is allowed as P.T.I., and $71.50 is taxable as a non-qualified dividend at 40.8%, resulting in a tax of $29.17. The worldwide tax for years one and two is $47.17. The Mid Case option results in a 17% decrease in the effective tax rate when compared to the Worst Case and is only 9% better than making no election.

Finally, if the original intent of the tax provision became a reality, the "Best Case" in Table B would be as follows. The taxpayer would be entitled to the 50% dividend received deduction along with the foreign tax credit as in the Mid Case for a worldwide tax in year one of $18. When a dividend distribution is paid in year two, only $10.50 would be available as P.T.I., leaving a dividend of $71.50. However, if the dividend were taxable as a qualified dividend at 20% plus the net investment income tax of 3.8%, the U.S. tax would be $17.02 resulting in a worldwide tax for years one and two of $35.02. The Best Case option reduces the tax by 35% in comparison to the Worst Case and is a slightly better alternative than holding shares in a U.S. domestic entity, as described below. Certainly, this option could be a real opportunity for an individual U.S. Shareholder.

The U.S. Domestic Holding Corporation

Another planning opportunity exists if an individual U.S. Shareholder were to hold investments in C.F.C.'s through a U.S. domestic corporation. Table C illustrates the tax results of this option under the same fact pattern as above.

TABLE C		
	Domestic Company Holds Shares of a C.F.C.	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
Non-U.S. Income	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**
G.I.L.T.I.		
Income	$82.00	–
Gross-up	$18.00	–
50% Deduction	$50.00	–
Tax Rate	21%	–
U.S. G.I.L.T.I. Tax	$10.50	–
F.T.C. (80% G.I.L.T.I. limitation)	-$14.00	–
F.T.C. Carryover	$0.00	–
U.S. Incremental Tax, Code §962(d)	$0.00	–

TABLE C		
	Domestic Company Holds Shares of a C.F.C.	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
Worldwide Tax, Year 1	**$18.00**	**$18.00**
Corporate Dividend from F.C.	$82.00	–
P.T.I., Code §959	-$82.00	–
Corporate 2nd Level of Tax	**$0.00**	**–**
Dividend to Shareholder	$82.00	$82.00
P.T.I., Code §962(d)	$0.00	$0.00
Net Dividend	$82.00	$82.00
Dividend Tax to individual	**$19.52**	**$19.52**
Worldwide Tax, Years 1 & 2	$37.52	$37.52
Worldwide Effective Tax Rate	**37%**	**37%**
Net Earnings After Tax, Years 1 & 2	***$62.48***	***$62.48***

In this calculation, the corporation gets a 50% dividend received deduction for a tax of $10.50 offset by the foreign tax credit of $14.40 as in the prior cases. The worldwide tax in year one is $18. In year two, the F.C. pays a dividend to the U.S. holding company; however, a full Code §959 deduction of P.T.I. is received. Therefore, no tax is due at the U.S. holding company level. The U.S. holding company pays a dividend to the U.S. Shareholder who pays a 23.7% dividend tax of $19.52 for a worldwide tax of $37.50.

When the worldwide tax costs of a U.S. domestic holding company holding an individual's shares in a C.F.C. is compared with the worldwide tax costs of an individual U.S. Shareholder holding shares in an F.C. that is not a C.F.C., the tax results are the same. We have come full circle.

Of course, different assumptions could have different outcomes. For example, if there were withholding taxes imposed by the non-U.S. country on the payments to the U.S. holding company or if there were different non-U.S. tax rates, the tax results would be different.

To summarize the results of this analysis, it is clear that if a U.S. Shareholder holds shares in a C.F.C. without any tax planning, the T.C.J.A. would result in an incremental tax cost of about 37%. The Code §962 election would be an option if it were possible to obtain favorable guidance on the application of both existing and new rules. At this point in time, holding shares in a domestic holding company appears to yield promising results.

	U.S. Shareholder Holds Shares of a C.F.C.				Domestic Company Holds Shares of a C.F.C.	U.S. Shareholder Holds Shares of a Non-C.F.C.
	No Election	Code §962 Election				
		Worst Case	Mid Case	Best Case		
Net Earnings After Tax, Years 1 & 2	$48.54	$44.64	$52.83	$64.98	$62.48	$62.48

OTHER PLANNING IDEAS

In addition to individual tax planning, there are other possible opportunities at the F.C. or subsidiary level to mitigate the impact of the T.C.J.A. Because of the peculiar application of the downward attribution rules in which the foreign parent is not eligible to be a C.F.C. even though its subsidiaries are C.F.C.'s, the possibility may exist to convert the parent company to the "trading company" where Subpart F and G.I.L.T.I. may not apply. Furthermore, it may be possible to convert corporate subsidiaries of foreign holding companies into pass-thru entities. However, deep dives into these strategies are beyond the scope of this article.

On a final note, one benefit resulting from the repeal of the downward attribution rule is the minimized tax exposure created by the Passive Foreign Investment Company ("P.F.I.C.") regime,[28] which sometimes applies to non-U.S. startups because of the proliferation of C.F.C.'s. An F.C. cannot be both a C.F.C. and a P.F.I.C. The C.F.C. rule trumps the P.F.I.C. regime.[29] Unfortunately, U.S. investors who own less than 10% of the F.C. could have P.F.I.C. issues that would result in current income gain or loss of qualified dividend treatment and the imposition of interest charges "deemed" ordinary and capital distributions.

CONCLUSION

In summary, non-U.S. emerging businesses looking to expand to the U.S. must carefully consider the growth path of their company, the availability of non-U.S. funding, as well as possible exit opportunities. Although it is true that venture capital funding is more abundant in the U.S. than in most other countries, many U.S. investors prefer to invest in U.S. corporations that hold the I.P. However, non-U.S. investors typically do not feel the same way. A strategic buyer could hold a new acquisition in his or her own offshore structure, shying away from a U.S. structure.

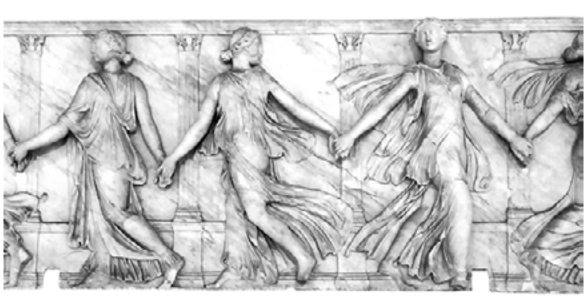
Furthermore, the reach of the U.S. tax authorities is extensive. Creating a Delaware Flip may not be the ideal solution. Creating a U.S. Topco is a one-way street and

28 Code §1291.

29 Code §1297(d).

is virtually irreversible without the imposition of U.S. taxes on inherent asset gains. Although the current tax rate of 21% is attractive, many are not sure that the rate is politically sustainable. In addition, certain tax benefits not discussed in this article – like the F.D.I.I. provisions, which provide for only a 13.125% tax on a portion of income derived from servicing foreign markets with products or services – have been challenged by the World Trade Organization as illegal export subsidies.

While there are no easy answers or silver bullets, tax-planning opportunities exist for both U.S. Shareholders and non-U.S. corporations to mitigate some of the tax impact of the more onerous provisions in the T.C.J.A. The incremental cost of planning and complying with the new U.S. tax provisions are not to be underestimated. F.C.'s and their investors should examine their corporate structures and create models of various alternatives before drawing conclusions.



JOINT AUDITS: A NEW TOOL TO COMBAT CROSS-BORDER TAX EVASION

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INTRODUCTION

A key message arising from international initiatives to eliminate cross-border tax avoidance is the need to strengthen cooperation and enhance transparency between (i) taxpayers and tax administrations and (ii) the various tax administrations that are stakeholders in a cross-border business operation. To this end, the O.E.C.D. has introduced a new array of legal tools, one of which stands out for its innovative features: the joint tax examination.[1] This article examines the initial pilot program between Italy and Germany, comparing the joint audit process to the traditional administrative and legal processes that taxpayers must follow to challenge a proposed adjustment under a normal transfer pricing examination.

The joint audit is intended to (i) effectively tackle cross-border tax evasion, (ii) address aggressive tax planning, and (iii) establish a new cooperative and transparent relationship between revenue bodies and taxpayers. From a practical standpoint, joint audits enable examiners of different tax administrations to work as a team in jointly performing examination activities. The collection of data, the analysis of data, and face-to-face interview are conducted jointly by examiners in each of the countries involved.

In recent years, the European Commission has been urged to adopt this new examination tool[2] to address cross-border tax issues such as transfer pricing, dual residence, and aggressive tax planning schemes. The goal is to reduce the backlog of unresolved mutual agreement procedures ("M.A.P.'s") by having the relevant tax administrations conduct the examination jointly, thereby eliminating the need for M.A.P. once an examination has been completed in one country. By its nature, M.A.P. is a lengthy process that leads to uncertainty of financial results for a multinational group and is costly for tax administrations and taxpayers.

The results of the pilot project have been mixed. On the positive side, a joint audits have the potential to reduce administrative burdens for both taxpayers and tax administrations because of their streamlined fact-finding process. In addition, tax administrations believe they result in more effective tax compliance. On the other hand, critical issues have been encountered that raise questions about the availability of enough resources for tax administrations to make this tool effective. Cooperation between the tax administrations has not been as great as anticipated. The two

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1 O.E.C.D. (Forum on Tax Administration), *Joint Audit Report*, Sixth Meeting of the O.E.C.D. Forum on Tax Administration, Istanbul (September 15-16, 2010), p. 2.

2 See Communication from the Commission to the European Parliament and the Council an Action Plan to Strengthen the Fight Against Tax Fraud and Tax Evasion, COM (2012) 722.

sides frequently adopted different views as to the same transaction or methodology. Staffing was problematic. Yet, if allowed to develop may be the standard way to conduct tax examination of a multinational enterprise in Europe.

WHAT IS A JOINT AUDIT?

In September 2010, the O.E.C.D. issued its first joint audit report commissioned by the Forum on Tax Administration in October 2009 (the "Report"). In accordance with paragraph 7 of the Report, a joint audit can be described as follows:

- Two or more countries join together to form a single team to examine one or more issues or transactions of one or more related taxable persons (both legal entities and individuals) with cross-border business activities, perhaps including cross-border transactions involving related affiliated companies organized in the participating countries and in which the countries have a common or complementary interest.
- The taxpayer jointly makes presentations and shares information with the countries.
- The joint audit team includes competent authority representatives, joint audit team leaders, and examiners from each country.

"Joint audits have the potential to reduce administrative burdens for both taxpayers and tax administrations because of their streamlined fact-finding process."

When referring to "cross-border transactions involving related affiliated companies," it appears the focus of a joint audit report is to facilitate streamlined examination activities that target transfer pricing issues of multinational enterprises. This is an area where tax adjustments by one country can produce massive increases in taxable revenue, often producing double taxation for the multinational enterprise unless a refund of tax is obtained in another jurisdiction.

Overall, the Report provides a useful set of principles and practical guidance for governments to perform joint audits. However, the Report clearly stipulates that joint audits must be performed in accordance with the boundaries set forth by domestic provisions and within the international legal framework of each country.[3] From a European standpoint, Directive No. 2011/16/EU[4] – on the administrative cooperation in the field of taxation ("D.A.C.") – introduced the first comprehensive legal basis for E.U. Member States to conduct joint audits. According to the D.A.C., a tax administration of a Member State may submit a joint audit request to another Member State through its competent authority. The Member State receiving the request must agree to proceed. If the request is accepted, the tax examiners of the requesting Member State may take the following steps:

- They may be present in the requested Member State offices where the tax authorities carry out their duties.
- They may be present during administrative inquiries carried out in the territory of the requested Member State.
- They may interview the taxpayers of the requested Member State.

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3 See the Report, at 8.

4 Council Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation, 2011 O.J. L 64/1.

- They may obtain access to documentation from the tax examiners of the requested Member State.[5]
- In light of the above features, the key components of a joint audit are as follows:
- The Member States may form a mixed single examination team, consisting of examiners from the requesting Member State and the requested Member State
- All of the examiners in the joint team are permitted to perform examinations in each of the countries involved with the same authoritative powers.
- Onsite examination activities may be performed in the requesting Member State and in the requested Member State

In 2012, the European Commission issued Communication No. 722/2012 in an effort to combat tax fraud and tax evasion, recommending Member State's develop methodologies for using simultaneous tax examinations[6] in the short term and for implementing the joint audit tool in the long term. Additionally, in the Tax Inspectors Without Borders report,[7] the O.E.C.D. referred to joint audits as a prominent way to share knowledge and build the capacity of a developing country's tax administration.

HOW COULD A JOINT AUDIT BE MORE BENEFICIAL THAN A STANDARD EXAMINATION?

As compared to a traditional examination, a joint audit may be more effective for resolving issues of double taxation in cases where it is fundamental to clarify the facts and circumstances in another country. In particular, a joint audit may be a better option with respect to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) complex tax structures involving aggressive tax planning schemes.

In the first two categories, a joint approach may reduce administrative costs for both tax administrations and taxpayers. For example, the costs derived from providing authorities with substantial documentation may be reduced by simultaneously sharing the same information with multiple revenue bodies. Moreover, joint audits may increase taxpayer certainty by enabling the relevant tax authorities to more quickly establish a joint position in the course of the examination process.

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5 See D.A.C., article 11.

6 The feature that substantially differentiates a joint audit from a simultaneous tax examination – another form of administrative cooperation – is that the latter does not entail the formation of a single audit team; rather, the examiners simultaneously and independently examine tax issues in their own territories with a view to exchanging any relevant information they obtain (see the Report, supra note 2, pp. 15-16).

7 Tax Inspectors Without Borders ("T.I.W.B.") is a joint initiative of the O.E.C.D. and the United Nations Development Programme ("U.N.D.P.") to build tax audit capacity. T.I.W.B. programs complement broader international efforts to strengthen co-operation on tax matters and improve domestic resource mobilization in developing countries.

In the third category, a joint audit is likely to increase transparency and eliminate legal boundaries that enable aggressive tax planning.[8] Indeed, many tax fraud schemes rely on a lack of transparency and communication between tax administrations, and many could have been prevented had the tax administrations established efficient channels for cooperation and information exchange.

Consequences of an Ordinary Italian Transfer Pricing Audit

In order to better understand the potential benefits of conducting a joint audit, it is worth considering the administrative burdens related to an ordinary transfer pricing assessment that results in an upward adjustment in one country without an immediate corresponding downward adjustment in the other country. The phases described below refer to the administrative procedure under the Italian legal framework, which does not differ significantly from the steps in other E.U. countries.

- **Examination Phase:** During the examination phase, examiners analyze the facts and evaluate the arm's length nature of the controlled transactions. In order to complete these examinations, the taxpayer must provide the examiners with a substantial amount of documentation and information. These include accounting and management entries, contracts, financial statements, and trial balances of each group company). Additionally, functional interviews are conducted with local and foreign employees. At the end of the examination, an examination report is issued to the taxpayers and a copy is submitted to the assessment unit of the Italian Revenue Agency. This phase may last up to two years.

- **Assessment/Negotiation Phase:** The assessment unit of the Italian Revenue Agency is in charge of reviewing the content of the examination report and issuing the final assessment. The unit also performs its own analysis and has the authority to increase, reduce, and even cancel the proposed adjustment issued by the examiners. Furthermore, conclusions must also be reviewed by different officers where the taxpayer is entitled to further defend their position. For this reason, officers of the assessment unit may ask the taxpayer for additional documentation and, in some cases, new analysis. An example might be new benchmark analysis, which is often very time-consuming. In this phase, the taxpayer may agree to a settlement with the office. However, if no settlement is agreed upon or if the settlement leads to double taxation, the taxpayer is left with two options, only: enter into M.A.P.[9] or initiate litigation according to domestic legal provisions.

- **M.A.P./Litigation Phase:** In Italy, M.A.P. is not an alternative to the litigation procedure used to prevent claims from the assessment becoming final. According to domestic legal provisions, the Italian Competent Authority cannot enter into an agreement with another competent authority that differs from a final settlement that is reached in the Assessment/Negotiation Phase or final court decision. To this end, in order to initiate M.A.P., taxpayers must (i) file a lawsuit under the domestic provisions, (ii) submit an M.A.P. request, and (ii) if such request is accepted, submit a request for the suspension of litigation.[10]

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8 See the Report, supra n. 2, at 9.

9 Where the other country signed a convention for the avoidance of double taxation with Italy and actually has an active M.A.P. team in operation.

10 The suspension is not automatic as the it requires the consent of the Italian Revenue Agency.

If the relevant tax treaty does not include an arbitration clause, the competent authorities are not obliged to reach an agreement. If the M.A.P. ends without an agreement, the suspended litigation will resume under domestic legal provisions. This phase may last up to ten years.

As above described, the ordinary transfer pricing audit process often includes three or four different assessments, which are conducted at different times by different persons.[11] The process is often lengthy and costly, and the outcome is highly uncertain both for tax administrations and taxpayers.

The goal of a joint audit is to limit administrative efforts through the early involvement of the competent authorities and to give certainty to taxpayers by establishing a transparent cooperation with the revenue bodies.

Joint Audit Pilot Project Between Italy and Germany

Following the European Commission's recommendation, the Italian and Bavarian tax administrations signed a memorandum of understanding regarding their intent to carry out one or more pilot joint audits on taxpayers with cross-border transactions between Italy and Bavaria. In 2013, the pilot project commenced and was divided into two phases: The first aimed to establish the grounds for performing the joint audit. The second was devoted to carrying out the specific examinations on a joint basis.

In the first phase, several meetings were held in Germany and Italy to coordinate group responsibilities for various tasks, such as the following:

- Identifying the relevant legal framework under which the joint audit would be performed
- Reaching an agreement on the tax issues to be addressed
- Identifying the criteria to select taxpayers for examination
- Forming two mixed teams of examiners, each composed of two Italian and two German examiners

Following the completion of the first phase, two multinational enterprises ("M.N.E.") were selected to be examined in connection with transfer pricing issues. The first company was headquartered in Germany with a subsidiary in Italy and the second was headquartered in Italy and with a subsidiary in Germany. The relevant legal framework was the D.A.C. and domestic law. At the start of the project, Germany had already implemented legislation allowing for joint audits. Italy introduced a joint audit provision into its domestic law in 2014, pursuant to the project.

The six-to-eight-month examination process resulted in an adjustment in prices between the associated companies. The adjustment was shared with the taxpayers involved and was agreed upon by the examiners and competent authorities of both countries. The agreement was the result of the jointly conducted examination.

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[11] These include (i) the examiners, (ii) the officers of the assessment unit, (iii) the competent authorities and, where the latter cannot some to an agreement, (iv) the judges. Moreover, in Italy, there are three level of courts (*i.e.*, first, second, and Supreme Court). Therefore, one transfer pricing assessment may become seven.

In each case, the examination team jointly examined the headquarters and then examined the subsidiary. Before each on-site examination, the examination team met to plan the examination activities, including identifying documents that would be requested and the taxpayer personnel to interview. At the end of each day, a daily examination report was drafted and signed by both the examiners and the taxpayers. In the daily examination report, all the activities, documents, and interviews were summarized.[12] The examination team also held several meetings with the taxpayers to share and discuss their findings. In order to standardize joint audit reports and official communications, the documents were drafted in English.

"A joint audit may be a better option with respect to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) complex tax structures involving aggressive tax planning schemes."

After finishing each examination, a final joint audit report was drafted. This report was used as grounds to issue an upward adjustment in one country along with a corresponding downward adjustment in the other country in accordance with domestic legal provisions.

The pilot project proved to be useful as it identified advantages and critical issues encountered during a joint audit. Moreover, it established a starting point for developing a more efficient solution to solve cross-border issues.

Some of the advantages of the joint audit pilot project were as follows:

- Joint audits lead to a material reduction of time needed to find shared positions between the countries involved.
- Joint audits decrease administrative burdens, related costs, and uncertainty.
- A joint audit allows for more taxpayer involvement, whereas M.A.P. is mostly limited to a discussion between competent authorities.
- The joint audit process is transparent and interactive, enabling the parties to find a solution in line with business functions, thereby fostering a more compliant environment where taxpayers see tax administrations as advisors rather than external agents to be kept outside of their business.
- A joint audit can address instances of double non-taxation, while M.A.P. can only address cases of double taxation.
- Joint audits are not unilateral tax rulings, as is the case with advanced price agreements. Therefore, State Aid risks are not an issue.
- Joint audits work.

The joint audit pilot project also highlighted certain critical issues:

- It is necessary to harmonize the legal basis for conducting joint audits. To this end, the Multilateral Instrument ("M.L.I.") may provide help in introducing the necessary tools.
- It is also necessary to harmonize the examination process among countries.
- English can be used as the standard for communicating and drafting documents; however, language can still be an issue when analyzing taxpayer contracts and other documents that are not in English.

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12 It is important to note that in Italy it is mandatory to draft a daily audit report, while in Germany it is not required.

- Staffing may pose an issue. In particular, it is necessary to have skilled examiners.
- Taxpayers cannot voluntarily enter into a joint audit.
- The outcome reached is not binding for tax administrations in the years not covered by the joint audit.

CONCLUSIONS AND NEXT STEPS

So far, M.A.P.'s have not been able to provide an efficient solution to the increasing number of double taxation controversies between E.U. and non-E.U. countries. The process is lengthy, costly, and highly uncertain – especially where arbitration is not mandatory. European competent authorities have been inundated with M.A.P. requests,[13] and the increased caseloads leave many instances of double taxation unresolved.

The pilot project conducted by Italy and Germany provides encouraging results. The two tax administrations found a shared position by jointly examining taxpayers and, in the process, avoided the burden of double taxation. The two countries are further developing this tool by investing additional resources in the international tax sector and selecting new joint audit cases. Moreover, other countries have shown interest in this project and are moving forward with first steps toward multilateral cooperation.

The pilot project demonstrated that both tax administrations are committed to the project's success. However, many questions still remain unanswered, particularly with respect to larger, more difficult cases. The pilot project revealed critical issues such as differences in domestic laws and potentially inadequate staffing resources if the number of the joint audits increases in future years. However, the main question is whether joint audits continue to be effective beyond the pilot stage.

13 "OECD Releases Mutual Agreement Procedure (MAP) Statistics for 2016," O.E.C.D.

INBOUND ACQUISITION DUE DILIGENCE UNDER U.S. TAX REFORM

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The Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") introduced broad changes to the Internal Revenue Code ("Code"). Many significant changes apply to U.S. businesses. Some of the most notable are (i) the reduction of the corporate income tax rate to a flat 21%; (ii) the introduction of a 20% deduction for certain business income of pass-thru entities, such as limited liability companies, S-corporations, and sole proprietorships; and (iii) temporary 100% bonus depreciation for certain new and used business or income-producing property.

Some of the most fundamental changes to the taxation of businesses apply to cross-border operations or investments. While there are fewer new inbound provisions, the new outbound rules are plentiful, and for a foreign person acquiring a U.S. company with non-U.S. operations, all of the new tax provisions may come into play.

These include the following:

- A one-time tax (often called the "transition tax") on accumulated post-1986 deferred foreign earnings of specified foreign corporations ("S.F.C.'s"), including controlled foreign corporations ("C.F.C.'s"), deemed to be repatriated under Code §965 for tax year 2017
- A new regime that imposes a tax on global intangible low taxed income ("G.I.L.T.I."), which is current foreign earnings of a C.F.C. net of a nominal rate of return on tangible property, under Code §951A
- A "participation exemption" (known as the "D.R.D.") for foreign-source dividends from a specified 10%-owned foreign corporation or C.F.C. under Code §245A, with an exception for hybrid dividends[1]
- The elimination of the ability to claim indirect foreign tax credits with respect to most dividends from foreign subsidiaries and considerable limitations on indirect foreign tax credits attributable to G.I.L.T.I. (as a result of the participation exemption)
- A reduced corporate tax rate on income from foreign-use goods and services, referred to as foreign derived intangible income ("F.D.I.I."), under Code §250
- A significant expansion of the definition of C.F.C. – and, therefore, the reach of the C.F.C. rules – under Code §951 (broadening the definition of U.S. Shareholder to include value and eliminating the requirement that a foreign

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[1] Technically, this new rule is a "dividend received deduction" rather than a "participation exemption" as commonly seen in the international tax context (*e.g.*, in the E.U. Parent-Subsidiary Directive and incorporating domestic laws of E.U. Member States). Notably, capital gains are not tax exempt under the new D.R.D. rule found in the T.C.J.A.

corporation must be controlled for 30 days before the C.F.C. rules apply) and Code §958(b) (in particular, relating to the downward attribution from foreign persons to related U.S. persons)

- Limitations on deducting interest from related and unrelated parties under Code §163(j)
- The disallowance of deductions for related party payments in hybrid transactions or with hybrid entities under Code §267A
- A new the base-erosion anti-abuse tax ("B.E.A.T."), a minimum tax on large corporations that make base-eroding payments to foreign related parties under Code §59A
- The interaction of the new rules with pre-T.C.J.A. provisions, in particular, the anti-deferral rules on certain C.F.C. income known as "Subpart F Income" and rules governing investments in U.S. property by a C.F.C.

Through the use of a hypothetical U.S. investment by a foreign investor, the following is a discussion on the U.S. Federal tax due diligence considerations. In order to cover the most significant changes to the Code under the T.C.J.A., the basic example is broad, allowing for modifications to provide for various scenarios that would trigger the various new rules.

As such, it is not meant to be an exhaustive list of all due diligence issues in an acquisition of a U.S. business by a foreign person. Not covered are investments into U.S. real estate, which are subject to a separate discussion in a future Insights edition. Further, it does not include state and local tax due diligence. Rather, it is an overview of the most significant new Federal income tax considerations of inbound acquisitions of cross-border businesses.

In addition, because of their importance to tax due diligence, we consider certain significant changes to provisions that apply primarily in the domestic context, such as the limitations to the use of net operating losses ("N.O.L.'s").

THE PROPOSED ACQUISITION

The hypothetical acquisition will consist of the following:

- A foreign investor seeks to make an inbound investment into the U.S. by purchasing a U.S. corporation (U.S. Co.).
- The investment includes a U.S. subsidiary (U.S. Sub.) as well as foreign subsidiaries, some of which qualify as C.F.C.'s. Others do not.
- U.S. Co. and U.S. Sub. are profitable.
- U.S. Co. and its subsidiaries each have a fiscal year that ends on June 30.
- The foreign investor wishes to close the acquisition before the end of 2018.
- The acquisition will be structured as a taxable stock acquisition in which the foreign parent (F.P. Co.) will acquire from the U.S. seller all of U.S. Co.'s shares.

NEW DUE DILIGENCE CONSIDERATIONS

Transition Tax

> ***Example 1:*** *For an illustration of this rule, assume that U.S. Co.'s C.F.C.'s (C.F.C. 1 and C.F.C. 2) are held via a holding company based in Luxembourg (Lux. HoldCo.). The C.F.C.'s have accumulated earnings that were not previously taxed in the U.S.*

The T.C.J.A. moves the U.S. toward a quasi-territorial tax system. Under the new law, U.S. corporations that receive foreign-source dividends from certain foreign subsidiaries are generally eligible for a 100% deduction with respect to such dividends under Code §245A. This 100% deduction applies to dividends distributed by qualifying foreign corporations to U.S. corporate shareholders after December 31, 2017. In effect, the 100% D.R.D. creates a participation exemption for dividends from certain foreign subsidiaries, as discussed below. While the transition tax also applies to U.S. individuals, the D.R.D. is limited to U.S. corporate shareholders of qualifying foreign subsidiaries.

As part of the transition to the new participation exemption regime, Code §965 imposes a one-time tax on accumulated post-1986 deferred foreign earnings of certain foreign corporations (*i.e.*, foreign earnings not previously subject to U.S. federal income tax), referred to as the "Code §965 income inclusion." This amount is the greater of such foreign earnings on one of two measuring dates.

The transition tax applies only to "specified foreign corporations" ("S.F.C.'s"), *i.e.*, C.F.C.'s or other foreign corporations in which a corporate U.S. Shareholder owns 10% or more. For this purpose, U.S. Shareholder generally means a U.S. person (individual and corporation) that owns 10% or more of the voting rights of the foreign corporation, or 10% or more of the voting rights or value for tax years of the foreign corporation beginning after 2017.

"U.S. corporations that receive foreign-source dividends from certain foreign subsidiaries are generally eligible for a 100% deduction."

The transition tax applies to the last tax year of the foreign corporation that began before 2018. With respect to the U.S. Shareholder, it applies to the tax year in which or with which the foreign corporation's tax year ends.

The transition tax rate is computed by applying a dividends received deduction under Code §965(c), which yields a tax rate of 15.5% on accumulated foreign earnings ("E&P") held in the form of cash or cash equivalents, and an 8% tax on all other earnings. A corporate U.S. Shareholder is entitled to a limited indirect foreign tax credit on foreign taxes paid or accrued with respect to the taxable portion of the Code §965 inclusion.

The transition tax liability, referred to as the "net tax liability," is eligible for deferral, through a special election, under which the taxpayer may pay the transition tax over eight tax years without interest or penalties.[2]

As part of its due diligence, the foreign investor should consider the following with respect to the transition tax:

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[2] Under a special rule for S-corporations, payment of the transition tax can be deferred upon election until a specified triggering event. C-corporations are not eligible for this deferral.

- Since U.S. Co., Lux. HoldCo., C.F.C. 1, and C.F.C. 2 are on a fiscal year that ends June 30, the transition tax will apply for the tax year that began on July 1, 2017, and ended on June 30, 2018. U.S. Co.'s fiscal year 2017 tax payments, including the transition tax liability, will be due by September 15, 2018. As a result, the foreign investor may own the U.S. Co. group at the time the transition tax liability is due and must understand the filing and payment requirements. Moreover, the foreign investor should review
  - U.S. Co.'s transition tax liability computations for accuracy, including
    - the determination of the Code §965 income inclusion,
    - the determination of the measuring date,
    - the computation of cash and cash equivalents, and
  - whether any anti-avoidance transactions were undertaken to reduce the transition tax liability.
- The foreign investor should determine whether an election to defer the transition tax liability is beneficial. Since the deferral is interest-free and without penalties, in most cases, the deferral election will be the best option. The tax representations and warranties of the purchase and sale agreement should include a provision requiring U.S. Co. to file a timely deferral election and make a timely payment for the first installment of the transition tax liability.
- The foreign investor should determine whether the estimated tax payments for the 2017 fiscal year take the transition tax liability into account. If they do not, interest and penalties may apply.
- The foreign investor should determine how the transition tax liability will impact the purchase price of the U.S. Co. group.
- The foreign investor should determine whether U.S. Co. will require an actual distribution from its foreign subsidiaries to pay the transition tax liability and, if so, how the distribution will affect the working capital and liquidity of C.F.C. 1 and C.F.C. 2. The E&P positions of C.F.C. 1 and C.F.C. 2 should be considered in this respect.

D.R.D.: Participation Exemption à l'U.S.A.

The following is based on Example 1 described in the previous section. C.F.C. 2 has U.S.-source income.[3]

As discussed above, the participation exemption (also referred to as the D.R.D.) for dividends under Code §245A, applies to foreign-source dividends received by a corporation[4] that is a U.S. Shareholder of an S.F.C. Foreign entities that are Passive Foreign Investment Companies ("P.F.I.C.'s"), described below, are excluded from

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3 Typically, foreign entities will not operate in the U.S. without establishing a separate legal entity. An exception may apply in the banking area in order to comply with significantly increased bank capital requirements.

4 The D.R.D. does not apply to dividends received from a R.I.C. or R.E.I.T. Individuals and S-corporations are not eligible to elect into this provision.

the D.R.D.[5] The D.R.D. is subject to a holding period defined under this rule.[6] For this purpose, U.S. Shareholder means a U.S. corporation that owns 10% or more of the S.F.C.'s voting rights or value.

Foreign-source dividends are dividends attributable to foreign earnings of the S.F.C. If the S.F.C. also derives U.S.-source income, dividends must be pro rated. The U.S. portion may be eligible for a dividend received deduction under a pre-T.C.J.A. rule[7] that is similar to the new D.R.D. rule for foreign-source dividends. In the case of 100% ownership in the S.F.C., the domestic portion should qualify for a 100% deduction. As mentioned earlier, capital gains are not covered under the D.R.D. unless treated as dividends under certain circumstances.[8]

The D.R.D. does not apply to hybrid dividends from a C.F.C. A hybrid dividend is an amount received from a C.F.C. for which the specified 10%-owned foreign corporation received a deduction or other tax benefit with respect to income tax. An example of a hybrid dividend is a payment from a Luxembourg C.P.E.C.[9] Further, if a C.F.C. receives a hybrid dividend from another C.F.C., the hybrid dividend is treated as Subpart F Income for the C.F.C.'s common U.S. Shareholder. No foreign tax credit is allowed in this case.

Subpart F Income is readily moveable income of a C.F.C., including passive-type income such as dividends, interest, rents, or royalties as well as taxable investments in "U.S. property." Under Code §951, Subpart F Income is subject to current taxation on a *pro rata* basis at the U.S. Shareholder's ordinary tax rate, without the requirement of a cash or property distribution.

The indirect foreign taxes attributable to dividends eligible for the participation exemption are not creditable. Nonetheless, a corporate U.S. Shareholder may claim a credit for indirect foreign taxes attributable to Subpart F Income.

As part of its due diligence, the foreign investor should consider the following with respect to the D.R.D.:

- Whether U.S. Co.'s capital investment in Lux. HoldCo. is treated as debt for Luxembourg tax purposes for which Lux. HoldCo. receives an interest deduction in Luxembourg: If this is the case, dividends from Lux. HoldCo. will be treated as hybrid dividends included in U.S. Co.'s Subpart F Income for U.S. Federal income tax purposes. As a result, the Lux. HoldCo. dividends will be subject to U.S. corporate income tax at 21% under the T.C.J.A.

- Whether the dividends received by Lux. HoldCo. from C.F.C. 1 or C.F.C. 2 are hybrid dividends: If this is the case, U.S. Co. will have Subpart F Income with

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5 Code 245A(b)(2). Note that in the event a foreign entity is a C.F.C. and would also qualify as a P.F.I.C., the C.F.C. and Subpart F rules prevail (Code §1297(d)).

6 Code §§246(c)(1)(A) and (5). In broad terms, a one-year holding period applies within a 731-day period starting on the date 365 days before the ex-dividend date. The U.S. Shareholder must own the S.F.C. throughout the entire holding period.

7 Code §245.

8 Under Code §1248.

9 See "A New Opportunity for Nonresident Aliens – Ownership in an S-Corporation" *Insights* 5, no 2 (2018).

respect to the dividends received by Lux. HoldCo. The Subpart F Income will be subject to current taxation at the 21% corporate income rate with a foreign tax credit being denied.

- Whether C.F.C. 2 performs any trade or business activities in the U.S. that could create a U.S. branch or permanent establishment: In this outside the banking business rather unlikely event, the D.R.D. would not be available for earnings attributable to C.F.C. 2's U.S.-source income. However, up to 100% of the U.S.-source dividend could be eligible for the domestic D.R.D. if C.F.C. 2 is 100% owned.

- Whether the Lux. HoldCo. and C.F.C.'s structure is efficient under current legislation in light of the D.R.D. and, as discussed below, G.I.L.T.I. and F.D.I.I.: Short-term considerations may be outweighed by the long-term perspective under applicable domestic and foreign tax law.

Income Inclusion for G.I.L.T.I.

The rule is illustrated using Example 1.

The T.C.J.A. introduced new Code §951A, which applies to C.F.C.'s and, in the same manner as Subpart F, imposes current taxation on a U.S. Shareholder's *pro rata* share of the G.I.L.T.I. of its C.F.C.'s. Note that, contrary to the D.R.D., G.I.L.T.I. applies to both individuals (including sole proprietorships, partnerships, and S-corporations) and C-corporations that are U.S. Shareholders. The significant difference is that a 50% deduction, as described below, applies unequivocally only to C-corporations, whereas the I.R.S. position on whether individuals may elect into this deduction is currently unclear.

The tax generally is imposed at ordinary income tax rates (*e.g.*, 21% for corporate U.S. Shareholders). However, corporate U.S. Shareholders are eligible for a 50% deduction on G.I.L.T.I. under Code §250 (reduced to 37.5% for tax years beginning after 2025). The Code §250 deduction generally will reduce the effective tax rate on G.I.L.T.I. to 10.5% (13.125% for tax years beginning after 2025). Further, U.S. Shareholders that are corporations are allowed to claim indirect foreign tax credits for foreign taxes paid or accrued on G.I.L.T.I. However, only 80% of the foreign tax is creditable. To render tax calculations even more complex, foreign tax credits relating to G.I.L.T.I. are subject to a separate limitation "basket." Any excess foreign tax credits not used in the current year are lost, since they may not be carried back or carried forward.

The tax on the G.I.L.T.I. inclusion applies for tax years of a C.F.C. beginning after 2018 and for the tax year of the U.S. Shareholder with which or within which the C.F.C.'s tax year ends.

Despite its name, G.I.L.T.I. is not limited to income from intangible assets. In broad terms, G.I.L.T.I. is a C.F.C.'s gross income, with the exception of (i) Subpart F Income, (ii) Subpart F Income eligible for the high tax kick-out exception, and (iii) dividend income from related parties[10] reduced by attributable deductions.

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[10] As defined under Code §954(d)(3) (control requirement with a threshold set at more than 50% ownership by vote or value). Attribution rules similar to the ones under Code §958 apply.

From an inbound perspective, income derived by the C.F.C. that is effectively connected with a U.S. trade or business is also carved out unless it is exempted from U.S. taxation under an income tax treaty.[11]

In addition, G.I.L.T.I. is computed by netting 10% of the C.F.C.'s tax basis in its depreciable tangible property attributable to G.I.L.T.I. For this purpose, a routine return of 10% on the U.S. Shareholder's aggregate *pro rata* share of the bases in depreciable tangible property of all C.F.C.'s is assumed under this new rule.

With respect to subsequent dividends paid by the C.F.C. to its U.S. Shareholder, the net U.S. corporate tax paid on the G.I.L.T.I. inclusion is treated as previously taxed income ("P.T.I."). The character of the dividend remains, and foreign withholding tax levied in the C.F.C.'s country of residence is creditable.

"G.I.L.T.I. is computed by netting 10% of the C.F.C.'s tax basis in its depreciable tangible property attributable to G.I.L.T.I."

As part of its due diligence, the foreign investor should consider the following with respect to G.I.L.T.I.:

- U.S. Co. may be subject to tax on G.I.L.T.I. from Lux. HoldCo., C.F.C. 1, and C.F.C. 2.
- The foreign investor should model U.S. Co.'s G.I.L.T.I. tax liability, taking into consideration certain factors:
    - The G.I.L.T.I. amounts with respect to C.F.C. 1 and C.F.C. 2 may be significant because as operating companies they may have low Subpart F Income.
    - Indirect foreign tax credits may not be significant if C.F.C. 1's and C.F.C. 2's taxable income is reduced by, *e.g.*, interest deductions. Further, rules that allocate and apportion expenses to foreign-source income, and thus reduce foreign-source income, may further reduce the indirect foreign tax credits since such credits may be claimed only against foreign-source income.
    - C.F.C. 1 or C.F.C. 2 may have low tax bases in their respective tangible property.
    - There may be an opportunity to increase U.S. Co.'s Subpart F Income through investments in U.S. property by its foreign subsidiaries under Code §956. That Code section creates a deemed dividend that is included in the U.S. Shareholder's Subpart F Income when the C.F.C. makes an investment in U.S. property. Thus, an investment in U.S. property under Code §956 includes acquiring tangible property located in the U.S., the right to use I.P. in the U.S., or the obligation of a U.S. person. Although Subpart F Income may be subject to tax at higher rates than G.I.L.T.I (*e.g.*, in the case of a U.S. Shareholder that is a corporation, 21% versus 10.5%), indirect foreign tax credits on Subpart F Income are not subject to the same limitations as indirect foreign tax credits on G.I.L.T.I. Further, as discussed above, the expense allocation and apportionment rules may increase the purported 10.5% tax rate on G.I.L.T.I.

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[11] Code §951A(c)(2)(A)(i)(I) defining "tested income" with reference to Code §952(b).

- It may be prudent to move I.P. to U.S. Co. to reduce G.I.L.T.I.

Export Subsidy for F.D.I.I.

> ***Example 2:*** *Assume that U.S. Co. and U.S. Sub. earn all their income from selling products and providing services, manufactured and physically performed in the U.S., to persons located outside the U.S. for consumption outside the U.S. In addition to unrelated parties, customers include C.F.C. 1 and C.F.C. 2. The U.S. Co. group's net income from these activities amounts to $100.*

For tax years beginning after 2017, the F.D.I.I. of a U.S. corporation is eligible for a 37.5% deduction (reduced to 21.875% for tax years beginning after 2025). This new rule does not apply to income of foreign branches, and it does not apply to individuals who operate a business in the form of an L.L.C.

Thus, in the example, assuming the U.S. Co. group is eligible and F.D.I.I. is also $100, then the U.S. Co. group would have $62.50 in taxable income subject to U.S. corporate income tax at the 21% rate. U.S. Co. would pay $13.12 in U.S. corporate income tax and have $86.88 in E&P. As a result, the effective tax rate on F.D.I.I. is 13.125% (16.4% for tax years beginning after 2025).

In broad terms, F.D.I.I. generally is income from (i) property that is sold by a U.S. corporation to any foreign person for foreign use or (ii) services provided by a U.S. corporation provided to any person, or with respect to property, not located in the U.S. F.D.I.I. excludes Subpart F Income and G.I.L.T.I. Similar to G.I.LT.I., F.D.I.I. is computed by netting 10% of the domestic corporation's tax basis in depreciable tangible property attributable to F.D.I.I.

Conceptually, G.I.L.T.I. and F.D.I.I. operate "in concert." Whereas depreciable tangible assets held by a C.F.C. would decrease and thus lower a U.S. Shareholder's income for G.I.L.T.I. purposes, the opposite applies for F.D.I.I. purposes. The higher the average bases are in depreciable tangible property of the U.S. corporation, the less income remains for the F.D.I.I. deduction.[12]

Special rules exist for property or services provided to domestic intermediaries or related parties. In general, if a U.S. corporation sells property to an unrelated person for further manufacturing or modification in the U.S., it is not treated as sold for foreign use, even if the unrelated person subsequently uses the property for foreign use. A similar rule applies to services provided to an unrelated person in the U.S., even if the person uses the services to provide foreign use services. If property is sold to a foreign related party, the sale is not a foreign use sale unless the foreign affiliate sells the property to an unrelated foreign party and the property is intended for foreign use. Income from services provided to a foreign affiliate is not foreign use unless such services are not substantially similar to services provided by the related party to persons located in the U.S.

For the purpose of F.D.I.I., the terms "sold," "sell," and "sale" are broadly defined and include any lease, license, exchange, or other disposition.

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[12] Similar to G.I.L.T.I., the calculations are complex. In determining F.D.I.I. a "deemed tangible income" return equaling 10% of the average bases in depreciable tangible property is applied.

As part of its due diligence, the foreign investor should consider the following with respect to F.D.I.I.:

- The foreign investor should review the U.S. Co. group's system for tracking exports of products and services to determine whether improvements to the tracking system are required in order to properly capture F.D.I.I.
- For the purpose of modeling the effect of F.D.I.I., the foreign investor should review sales of products and services by U.S. Co. and U.S. Sub. to determine whether they constitute foreign use property or services. This includes sales to C.F.C. 1 and C.F.C. 2, which may meet the definition of foreign use. The more profitable the U.S. Co. group becomes due to its foreign use activities (*i.e.*, the higher its income from sales of products or services to foreign customers is over its tangible property), the higher the tax benefit (*i.e.*, lower effective tax rate).
- Unless re-invested, profits derived by U.S. Co. are subject to limitations under accumulation rules described below. Dividend distributions by U.S. Co. to its foreign shareholder are subject to 30% U.S. withholding tax that could be reduced under an applicable income tax treaty.

Interest Deductibility

> ***Example 3:*** *The foreign investor is planning to fund U.S. Co. in order to acquire a U.S. company. The loan will be granted at arm's length with a five-year term. U.S. Co. has obligations, vis-à-vis its current owner, that should be transferred to the foreign investor upon acquisition.*

Under Code §163(j) as amended by the T.C.J.A., the deductibility of net interest expense (*i.e.*, interest expense in excess of interest income) is limited to 30% of E.B.I.T.D.A. (earnings before interest, taxes, depreciation, and amortization) for tax years beginning before 2022, and 30% of E.B.I.T. thereafter. Under the revised rules, the limitation applies to business interest paid by U.S. debtors to related or unrelated parties.[13] The Code §163(j) limitation is not subject to a grandfathering rule. Accordingly, debt issued before the enactment of the T.C.J.A. falls under this new rule. The disallowed interest deductions may be carried forward indefinitely. However, carryovers of disallowed interest are treated as items of pre-change loss that are subject to the Code §382 limitation described below.[14] For coordinating rules with respect to interest payments that could also fall under the base erosion limitation rules see below.

If, in comparison, the foreign investor should choose to fund U.S. Co. by means of equity contribution, this limitation would not apply. While, on the one hand, repayments of capital are not tax deductible for the U.S. corporate payor, on the other hand, they are not subject to U.S. withholding tax.

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[13] "Business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business (Code §163(j)(5)). Because the investment interest limitation under Code §163(d) (investment interest) does not apply to corporations, Code §163(j) typically applies unless the trade or business is excluded from the definition (*e.g.*, certain real estate related obligations upon exercising an election).

[14] Code §382(d)(3) as amended by the T.C.J.A.

As part of its due diligence, the foreign investor should consider the following with respect to the Code §163(j) interest deduction limitation:

- The foreign investor should perform a review of U.S. Co.'s and U.S. Sub.'s debt obligations to determine the effect of any disallowed net interest expense on the U.S. Co. group's effective U.S. Federal corporate income tax rate.

- Implications under Code §382 for pre-acquisition debt should be analyzed.

- If it is determined that debt funding is feasible, the withholding tax position of the foreign debtor – in this case, the foreign investor – should be analyzed. While the 30% U.S. withholding tax may be lowered or even eliminated under an applicable income tax treaty, documentation (Form W-8)[15] and reporting obligations (Forms 1042-S and 1042) apply in order to benefit from treaty relief. The exemption for portfolio obligations[16] does not apply to 10% shareholders.[17]

- Before extending and/or entering into new loan agreements, arm's length interest rates should be determined. Depending on the facts, reference could be made to the Applicable Federal Rates ("A.F.R.") published monthly by the I.R.S. on its website. Alternatively, a transfer pricing study should be conducted.

Minimum Tax on Base-Eroding Payments

> ***Example 4:*** *The facts are as described in Example 3 with the exception that, based on forecasts, the U.S. Co. group is expected to generate average annual gross receipts in excess of $500 million in the very near future.*

Code §59A imposes a minimum tax (*i.e.*, a tax in addition to the taxpayer's regular income tax liability), referred to as the B.E.A.T., on large C-corporations (*i.e.*, corporate shareholders other than R.I.C.'s, R.E.I.T.'s and S-corporations) that make deductible payments (*e.g.*, interest and royalties) to related foreign persons. The B.E.A.T. is intended to apply to taxpayers that significantly reduce their U.S. tax liability through deductible payments to related foreign persons. In the case of foreign corporate payors, only gross receipts producing income effectively connected with a U.S. trade or business are taken into consideration.

In broad terms, the B.E.A.T. applies to a taxpayer that reduces its tax liability to an amount that is 10% of its modified taxable income. Modified taxable income is computed under the rules of Code §59A.

Because credits reduce the regular tax liability and potentially[18] increase B.E.A.T. liability, this new rule can be viewed as a modified alternative minimum tax ("A.M.T.").

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15 For foreign individuals this would be Form W-8BEN; foreign corporate beneficial owners would furnish Form W-8BEN-E.

16 Code §871(h) for individuals and Code §881(c) for corporations.

17 As defined under Code §871(h)(3)(B)(i) for corporations. The term 10% shareholder is to be distinguished from the U.S. Shareholder definition under the Subpart F regime described in the foregoing.

18 These include R&D credits under Code §41 and 80% of other credits listed in Code §38 not exceeding a specified cap.

The following are examples of base erosion payments:

- Royalties
- Interest
- Payments for the acquisition of property giving rise to a depreciation or amortization
- Payments for services (except for services eligible for the Service Cost Method)

With respect to interest payments that would fall under this rule, note that the Code 163(j) limitation described above is applied first to unrelated party payments. As a result, adjusted taxable income is increased and more related party interest will be caught by the B.E.A.T. regime.

Certain payments to foreign affiliates are not considered base-eroding payments. Inter alia, these include the following:

- The cost of goods sold ("C.O.G.S."),
- Payments to the extent they are already subject to the 30% withholding tax under U.S. tax law
- Payments for certain intercompany services

Absent further guidance, it is currently not clear whether manufacturing royalties that are embedded in C.O.G.S. are excluded for purposes of the B.E.A.T. calculation.

The B.E.A.T. applies to corporations with average annual gross receipts of at least $500 million over a three-year period and with a "base erosion percentage" of at least 3% (2% in the case of financial institutions). The average annual gross receipts are measured on a worldwide group basis. Thus, for example, a foreign-parented group must aggregate the U.S. gross receipts of all of its controlled U.S. subsidiaries and U.S. branches, to determine whether the B.E.A.T. applies to any subsidiary. The base erosion percentage is the ratio of the base erosion tax benefits to total deductions (with some exceptions, including N.O.L. deductions).

As part of its due diligence, the foreign investor should consider the following with respect to the B.E.A.T.:

- In the fact pattern, the U.S. Co. group currently does not meet the gross receipts threshold for the B.E.A.T. However, since its gross receipts are expected to substantially increase in the near future, F.P. Co. is presented with the opportunity to structure intercompany transactions to avoid or reduce the effects of the B.E.A.T.
- F.P. Co. should determine which payments made by U.S. Co. and U.S. Sub. are potential base-eroding payments for B.E.A.T. purposes once the threshold is exceeded.

Deductibility of Hybrid Payments

> ***Example 5:*** *U.S. Co. made a loan to a foreign disregarded entity ("F.D.R.E.") wholly owned by U.S. Sub. F.D.R.E. is a hybrid entity (i.e., treated as a*

corporation for non-U.S. tax purposes but fiscally transparent from a U.S. tax perspective).

Code §267A disallows a deduction for certain related party amounts (i) paid or accrued in hybrid transactions or (ii) entered into with hybrid entities.

A related person for purposes of this rule is defined as (i) an individual, corporation, trust, or estate that controls, or is controlled by, the payor, or (ii) a corporation, partnership, trust, or estate that is controlled by the same person(s) that controls the payor.[19]

A related party amount is any interest or royalty paid or accrued to a related party to the extent that the amount is (i) not included in the income of the related person under the tax law of its country of tax residence, or (ii) the related party is allowed a deduction in that country. An exception applies to income that the U.S. Shareholder must include under the Subpart F regime of Code §951(a). A hybrid transaction involves a payment of interest or royalties from a U.S. person when the receipt of such payment is not taxable in the foreign country or the recipient is entitled to a deduction. A hybrid entity is (i) treated as transparent for U.S. Federal tax purposes but not for tax purposes in a foreign country or (ii) treated as transparent in the foreign country but not in the U.S. (referred to as a "reverse" hybrid entity).

Where payments involve certain foreign collective investment vehicles such as open-ended investment funds under German law, a mismatch of income and deductions could arise. The Code does not address these scenarios.

As part of its due diligence, the foreign investor should consider the following with respect to Code §267A:

- The interest expense generated by U.S. Sub. (via F.D.R.E.) is offset by U.S. Co.'s interest income, resulting in a "wash" from a U.S. tax perspective, assuming no other limitations apply (*e.g.*, dual-consolidated-loss limitations). It is unclear whether Code §267 disallows the deduction in this case. On the one hand, a deductible interest payment is made by a hybrid entity. On the other hand, the transaction does not appear to erode the U.S. tax base as intended to be addressed by this new rule.
- In analyzing the group structure, the foreign investor should confirm whether there are any entities that are treated as fiscally transparent in their countries of tax residence but not in the U.S. If a foreign subsidiary is determined to be a reverse hybrid, any payments of interest or royalties made to it by U.S. Co. or U.S. Sub may be disallowed.
- In its negotiations with the seller, the foreign investor should factor in this potential tax exposure.

Additional Changes Relevant in an M&A Context

A foreign investor should consider additional changes set forth by the T.C.J.A. with respect to future restructurings of the U.S. target:

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[19] For corporations direct or indirect ownership of more than 50% by vote or value is required; for partnerships, trusts, and estates the threshold is direct or indirect ownership of more than 50% by value of the beneficial interest. Attribution rules under Code §958 apply.

- The definition of I.P. under Code §936(h)(3)(B) has been expanded to include goodwill, going concern value, workforce in place, and any other item the value or potential value of which is not attributable to tangible property or the services of an individual.[20] In addition, under the T.C.J.A. revised Code §936(h)(3)(B) no longer stipulates that I.P. must have substantial value independent of the services of an individual. Consequently, certain transfers of these assets by a U.S. person to a foreign corporation will be subject to outbound transfer rules for intangibles under Code §367(d) or transfer pricing rules under Code §482. Further, the law states that the Secretary shall have the authority to specify which method must be used to determine the value of intangible property with respect to outbound restructurings of U.S. operations as well as intercompany pricing allocations. This is accomplished through the amendment of Code §482 as well as granting authority under Code §367 to permit the use of aggregate basis valuation and the application of the realistic alternative principle.

- The active trade or business exception has been repealed for certain outbound non-recognition transfers by U.S. persons.[21] Thus, transfers of property used in an active trade or business will no longer qualify as a tax-free organization, reorganization, or liquidation.

- A U.S. corporation is required to recapture post-2017 branch losses when substantially all of a foreign branch's assets (as defined in Code §367(a)(3)(C)) are transferred to a 10%-owned foreign corporation. The recapture amount (*i.e.*, the transferred loss amount) is equal to the branch's previously deducted loss amount after 2017 (and before the transfer) reduced by any taxable income of the branch in subsequent years (but before the close of the transfer year) and any gain related to an overall foreign loss recapture amount.

Unintended C.F.C.'s

> ***Example 6:*** *The foreign investor, F.P. Co., holds a foreign subsidiary ("F. Sub.").*

The T.C.J.A. revised the constructive ownership rules of Code §958(b) to include downward attribution from a foreign person.

As a result, any stock owned by F.P. Co. will be attributed to U.S. Co. Since F.P. Co. wholly owns F. Sub., all of F. Sub.'s stock will be treated as owned by U.S. Co., and thus, F. Sub. will be a C.F.C.

Since U.S. Co. will not directly or indirectly own any F. Sub. stock (*i.e.*, it will not have actual direct or indirect ownership in F. Sub.), no U.S. Federal tax liability will arise under the Subpart F regime with respect to its constructive ownership of F. Sub. and F. Sub.'s status as a C.F.C.

Nonetheless, any post-acquisition restructuring should consider the C.F.C.-status of the foreign entities. For example, if F. Sub is a C.F.C. under the downward attribution

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[20] This provision overturns several recent Tax Court cases holding that assets such as workforce in place and goodwill are beyond the scope of the statutory definition of "intangible property."

[21] Code §367(a)(5).

rule, the group should not be restructured in such a manner that U.S. Co., directly or indirectly, owns F. Sub. stock because, in that case, U.S. Co. may have Subpart F Income or G.I.L.T.I. with respect to F. Sub.

Further, if F. Sub. is a C.F.C. under the downward attribution rule, the group should not be restructured in such a manner that F. Sub. makes or receives a hybrid dividend to or from another C.F.C. and both F. Sub. and the other C.F.C. have a common U.S. Shareholder. In that case, the common U.S. Shareholder will have Subpart F Income under Code §245A, as discussed above.

"P.F.I.C. status imposes a special tax and interest charge on any U.S. person that receives an excess distribution."

N.O.L.'s

The T.C.J.A. amended the rules on deducting N.O.L.'s for the following limitations and benefit. For losses arising in tax years beginning after 2017, a taxpayer may deduct an N.O.L. against 80% of its taxable income (determined without regard to the N.O.L. itself). Under prior law, N.O.L.'s could be deducted against 100% of a taxpayer's taxable income. For losses arising in tax years beginning after 2017, N.O.L.'s may be not be carried back but may be carried forward indefinitely. Under prior law, N.O.L.'s could be carried back two years and carried forward 20 years.

In our example, if U.S. Co. is a profitable company, the new limitations on N.O.L.'s may not be relevant.

However, with respect to pre-acquisition losses, U.S. Co. will be subject to limitations on deducting N.O.L.'s under Code §§269 and 382 as a result of the ownership change.

ONGOING CONSIDERATIONS

In addition to the items to be addressed regarding the T.C.J.A. changes, the following rules under pre-T.C.J.A. law are still relevant and should be taken into account:

P.F.I.C.'s

A P.F.I.C. is defined as any foreign corporation in which (i) 75% or more of its gross income for the taxable year consists of passive income or (ii) 50% or more of its assets consist of assets that produce, or are held for the production of, passive income (such as stocks, bonds or cash).[22]

A typical P.F.I.C. is an offshore investment company or mutual fund, although P.F.I.C. status can be a potential issue for any foreign corporation, especially if the corporation has large cash reserves or is in the services business outside the U.S.

A foreign company that is a C.F.C. and a P.F.I.C. will be subject to the C.F.C. and Subpart F rules. If the foreign company is not a C.F.C., P.F.I.C. status imposes a special tax and interest charge on any U.S. person that receives an excess distribution. An excess distribution is a current distribution that exceeds 125% of the average distributions over the prior three years. The excess distribution is deemed attributable to profits earned in an earlier year, as determined under a prescribed formula. In addition, gain on the sale of stock in a P.F.I.C. may be taxed at ordinary income rates and also be subject to an interest charge under the computations that apply to excess distributions.

[22] Code §1298

Two elections are available for U.S. persons with P.F.I.C.'s.[23] In broad terms, as a result of an election, the U.S. person is taxed on a current basis. However, neither of these elections avoids taxation completely.

Anti-Accumulation Rules

U.S. tax law contains provisions that impose an additional corporate tax on earnings and profits that are accumulated beyond the reasonable needs of the business.[24] The tax is imposed at a rate of 20% of the unreasonable accumulation.

For the accumulated earnings tax[25] to apply, the earnings must be retained to avoid income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being distributed.[26] The fact that the earnings and profits of a corporation are permitted to accumulate "beyond the reasonable needs of the business" is determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation proves otherwise by the preponderance of the evidence.[27] If a corporation is a holding or investment company, it is *prima facie* evidence of a tax avoidance purpose.[28]

Among others, the following grounds for an accumulation indicate that it is reasonable:

- To provide for a *bona fide* expansion of business or replacement of plant
- To acquire a business enterprise through purchasing stock or assets
- To provide necessary working capital for the business (*e.g.*, for the procurement of inventories)
- To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation
- To provide for the payment of reasonably anticipated product liability losses
- To provide for realistic business contingencies, including possible lawsuits[29]

Among others, the following facts indicate that an accumulation is unreasonable:

- Loans to shareholders or the expenditure of funds of the corporation for the personal benefit of the shareholders

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23 These are the mark-to-market election for marketable stock (*e.g.*, traded on a stock exchange) (Code §1296) and the Qualified Electing Fund election (Code §1293).

24 Code §531.

25 For tax years after 2012, the rate of tax is 20% of "accumulated taxable income," which is defined under Code §535 and is, in general, taxable income subject to certain adjustments. Prior to the change in law, the rate of tax was 15%.

26 Code §532; Treas. Reg. §1.532-1(a)(1).

27 Code §533; Treas. Reg. §1.533-1(a)(1).

28 Code §533(b); Treas. Reg. §1.533-1(a)(1).

29 Treas. Reg. §1.537-2(b). See *Knight Furniture Co. v. Commr.*, T.C. Memo 2001-19 (class action lawsuit pending).

- Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons
- Loans to another corporation, the business of which is not that of the taxpayer, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer and such shareholder or shareholders are in control of both corporations
- Investments in properties or securities that are unrelated to the activities of the business of the taxpayer
- Retention of earnings and profits to provide against unrealistic hazards[30]

In light of the accumulated earnings tax exposure, it may be appropriate to have U.S. Co. make distributions to its shareholders from time to time to avoid the accumulated earnings tax. The Treasury has repeatedly emphasized its intent to revise this rule.

N.O.L.'s – Change of Ownership Rules Under Code §382 and §269

From a U.S. tax perspective, the use of N.O.L.'s may be

- limited where there is a substantial change of shareholders (*i.e.*, an increase of more than 50 percentage points by one or more shareholders owning, directly or indirectly, at least 5% of the loss company over the preceding three years)[31] or
- disallowed in the case of tax avoidance or evasion.[32]

Anti-Inversion Rules

The U.S. employs rules intended to prevent a domestic multinational company from undertaking a restructuring, merger, or acquisition that has the consequence of replacing the group's domestic parent company with a foreign parent company. This type of transaction is commonly referred to as an inversion.[33]

Anti-inversion rules have remained under the T.C.J.A. Final anti-inversion regulations were issued by the Treasury and the I.R.S. on July 11, 2018.[34]

FINAL POINTS

As demonstrated above, the changes to the Code's international provisions introduced by the T.C.J.A. are significant, particularly with respect to outbound

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30 Treas. Reg. §1.537-2(c).

31 Code §382.

32 Code §269.

33 Code §7874.

34 Final regulations were published in the Federal Register on July 12, 2018. With some modifications, these regulations finalize the temporary and proposed regulations released on April 8, 2016. The temporary regulation was invalidated in *Chamber of Commerce of the United States v. I.R.S.*, No. 1:16-CV-944–LY (W.D. Tex. Sept. 29, 2017), appeal docketed, No. 17-51063 (5th Cir. Dec. 1, 2017) for lack of prior notice and comment.

transactions. An inbound acquisition of a U.S.-parented multinational entity will encompass the new outbound considerations.

Many of the new regimes (*e.g.*, G.I.L.T.I., F.D.I.I., and B.E.A.T.) are computation-driven and have many variables. As a result, tax modeling in the acquisition process will become more significant and complex.

Additionally, O.E.C.D. countries are currently moving toward implementing the B.E.P.S. Action Plan. Already, the E.U. has issued two directives, A.T.A.D. 1 and A.T.A.D. 2, which implement certain B.E.P.S. actions in two phases. As a result, tax due diligence and modeling must include consideration of such recent and anticipated reforms.

In the light of changes under the T.C.J.A., foreign investors may want to avoid "buying-into" into new rules such as G.I.L.T.I., F.D.I.I., and B.E.A.T. by keeping the foreign group separate. One important consideration in this context is, however, the longevity of these new rules. Except for the lowered corporate income tax rate of 21%, most of the changes are subject to sunset. The chances of their survival are largely tied to the outcomes of the 2018 and 2020 elections. While proponents of the new rules stress the opportunity to spur investment, boost economic growth, and create jobs, these benefits come at a high price – namely, a significant increase in the nation's debt. The current administration's enthusiasm is not shared by everyone. A foreign investor must decide whether the incentives outweigh the pitfalls and, even more, on how much he or she is willing to rely on legislation that is subject to numerous open issues and an uncertain future.

BLOCKCHAIN 101

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Tags
Bitcoin
Blockchain

Blockchain has recently been in the spotlight, mostly due to the 2017 surge in cryptocurrency values and the rise of initial coin offerings ("I.C.O.'s"). Many legal advisors have clients who use or wish to use blockchain in their businesses, and yet, the actual technology is often not discussed in the legal field.

Blockchain is notable because it allows different parties to collaborate without trusting each other. No trust is required because the technology is designed to (i) validate the information stored on the blockchain and (ii) make that information difficult to alter retroactively.

HISTORY OF BLOCKCHAIN

Q 1: How Did the Technology Develop?

The idea behind blockchain was originally developed in 1991 by a group of individuals attempting to timestamp digital documents.[1] As such, blockchain is based on a timestamp server, which works by widely publishing information to a decentralized network that collectively checks the validity of the timestamp.

After the 2008 financial crisis, confidence in financial institutions was low, and as an alternative, the idea of a decentralized payment network was seriously considered. Around this time, Satoshi Nakamoto used the blockchain concept to create the decentralized digital currency Bitcoin.[2]

DEFINITION OF BLOCKCHAIN

Q 2: Are Blockchain and Cryptocurrency the Same?

No. Blockchain is the technology behind cryptocurrency.

Q 3: Technically Speaking, How Does Blockchain Work?

Blockchain is a distributed database that maintains a list of blocks.

As explained later, every block is composed of a certain number of records, including the history of every previous block up until its creation. This results in the blocks essentially being linked, or "chained," to each other, hence the term "blockchain." It can best be illustrated as follows:

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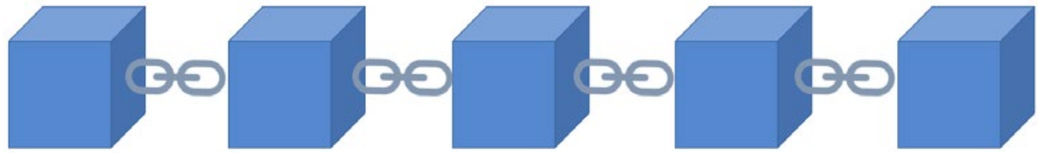
1 Stuart Haber, W. Scott Stornetta, "How to Time-Stamp a Digital Document," *Journal of Cryptology 3,* no. 2 (1991): pp. 99-111.

2 Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," Nakamoto Institute, October 31, 2008. For a discussion of cryptocurrency, see "Tax 101: Virtual Currency - What Is It? And How Is It Taxed?" *Insights 4,* no. 12 (2017).



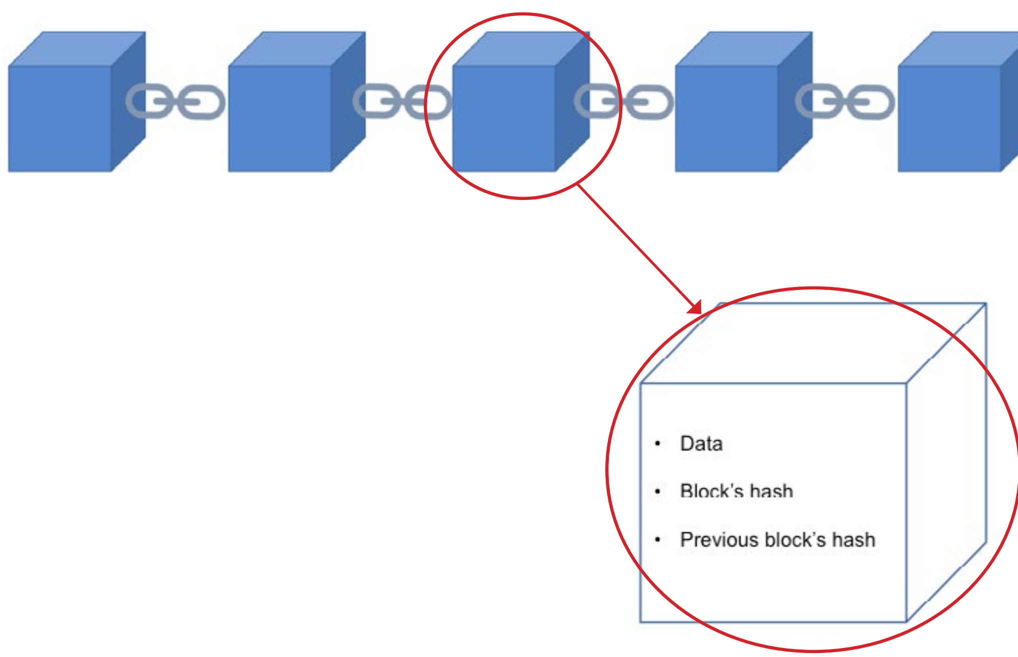
The entire chain is encrypted and every transaction is linked to a unique hash (discussed below) that is easy to verify and almost impossible to falsify because blockchain is maintained by a network of computers, also called "nodes." The nodes within a network work independently to process mathematical formulas and update the database. Once one node has solved an equation, the result is shared within the network, and if a certain level of consensus is reached, the blockchain is updated. This is known as proof of work (discussed in detail below).

Depending on the relevant blockchain, the network can be decentralized, or it can be kept among a group of accredited users.[3] This is often referred to as a "blockchain network." Similarly, a blockchain can be public or private, depending on the intended use.

Q 4: What Is a Block?

A block is composed of three items:

- Data
- The hash of the block
- The hash of the previous block



[3] See, for instance, the Australian stock exchange ("ASX Chess Replacement," ASX.).

Blocks contain previous transactions (if any) in the chain and incomplete transactions that are waiting for validation from the nodes. Once approved, these transactions become the data stored on a particular block.

> *"Blockchain allows for transparency, immutability, traceability, auditability, and authentication of a specific transaction."*

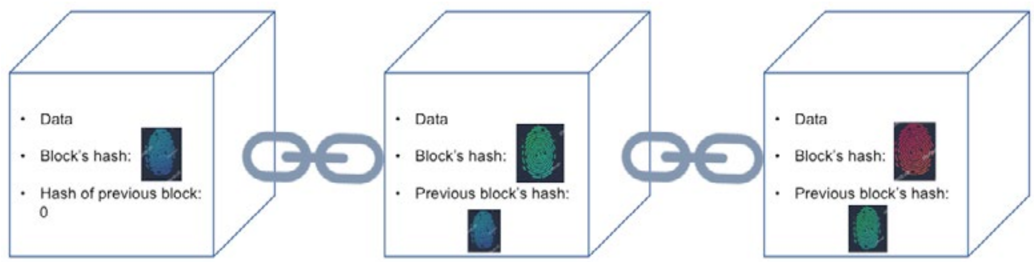
Q 5: What Type of Data Is Contained in a Block?

The type of data stored in a block depends on the blockchain it is a part of. For instance, if the block is part of the Bitcoin blockchain, the data it contains will include the sender, the receiver, and the number of transferred Bitcoins.

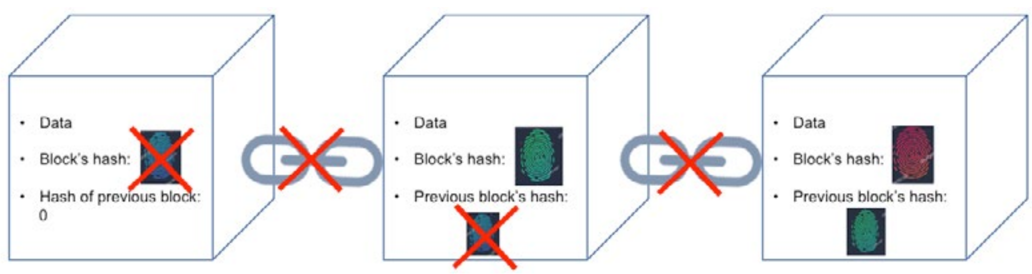
Q 6: What Is a Hash?

A hash is a unique series of letters and numbers that identifies a validated block. As such, it constitutes a cryptographic signature, similar to a fingerprint. When the block's underlying transactions are validated by the network, its hash is calculated.

The hash of the previous block is always contained in a block, along with its own hash.



This constitutes one level of blockchain security. If a block is altered, its hash will change, and the chain will be broken because the subsequent block contains a historical reference that no longer matches with the previous block's new hash.



Given that computers nowadays are very powerful, it is possible to recalculate the hashes of the blockchain to recreate the subsequent blocks. To enhance its security, the technology also contains a proof of work system.

Q 7: What Is Proof of Work?

Proof of work is a security mechanism that slows down the creation of new blocks, by requiring formulas to be solved and verified before the database is updated. It is the reason why blockchain does not require the parties' trust.

Proof of work is best illustrated through the example of Bitcoin. On average, the Bitcoin blockchain is updated every ten minutes with a new block of transactions. Bitcoin blocks contain several Bitcoin transactions that are waiting for approval from the network in order to be validated and completed. All the nodes compete against each other to solve a mathematical formula in order to approve the transactions contained in the block. The first node to solve the formula adds in a specific block of transactions. All other computers check and verify that the formula was solved correctly. If more than 50% of computers agree, the block of transactions is included in the chain.

USE OF BLOCKCHAIN

Q 8: What Is the Purpose of Using Blockchain Technology?

As explained earlier, blockchain allows for certain transactions to be carried out in a safe and almost unalterable way. As a result, blockchain allows for transparency, immutability, traceability, auditability, and authentication of a specific transaction.

Q 9: What Is the Link Between Smart Contracts and Blockchain?

A smart contract is the coded version of contractual-like arrangements. These codes are stored inside the blockchain and result in self execution of the contract, through the blockchain, if the terms of the coded agreement are met.

Q 10: What Are Other Potential Applications?

In addition to cryptocurrencies and smart contracts, potential examples of how blockchain can be used are the following:

- Food safety – Walmart and IBM use blockchain technology to increase the transparency and the traceability of the food supply chain.
- Diamond sourcing – Everledger and IBM use blockchain to track and reduce fraud in the diamond industry by tracing a diamond's origin, quality, and history.
- Stock markets – The Australian stock exchange has announced it will replace its traditional clearing system with blockchain technology.[4]
- Venture capital – In 2017 dozens of small companies raised millions in I.C.O.'s that use blockchain technology. In July 2017, the S.E.C. announced that some of the coins issued through these I.C.O.'s are securities and are subject to securities laws.[5] As a result, I.C.O.'s may now be subject to securities laws.
- Corporate records – Delaware has amended Delaware General Corporation Law to provide statutory authority for Delaware corporations to use networks of electronic databases, such as the blockchain, for the creation and maintenance of corporate records, including a corporation's stock ledger.[6]

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4 "ASX Chess Replacement."

5 S.E.C., "The Treatment of These Coins as Stock for Tax Purposes Depends on Their Rights and Powers," release no. 81207, July 25, 2017. See "Tax 101: Virtual Currency."

6 See §§151(f), 224, and 232(c) of the Delaware General Corporation Law.

CONCLUSION

Because it is a decentralized system, blockchain can eliminate the need for intermediaries, such as banks, lawyers, and brokers – which can have a wide appeal to clients. Advisors should continue to monitor the evolution of this technology and the potential implications for clients, as well as the legal industry.

HAVE YOU INHERITED A P.F.I.C.? – WHAT IT MEANS TO BE A U.S. BENEFICIARY

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Tags
Foreign Estate
Foreign Nongrantor Trust
Indirect Ownership
P.F.I.C.

In today's global environment, it is not surprising to find that a beneficiary of a foreign estate or trust is living in the U.S. An interest in a foreign trust can be problematic for the beneficiary if the trust invests in a foreign "blocker" corporation that holds passive assets (such as stocks and securities) or a foreign mutual fund. U.S. tax law imposes special rules on U.S. direct and indirect owners of passive foreign investment companies or ("P.F.I.C.'s").

A P.F.I.C. is defined as a foreign corporation if it meets either the income test or the asset test:

- ***The Income Test*** – At least 75% of its gross income is "passive income."
- ***The Asset Test*** – At least 50% of its assets constitute passive assets (*i.e.*, assets producing, or held for the production of, passive income).[1]

Passive income is defined by reference to special rules applicable to controlled foreign corporations ("C.F.C.'s"), namely the rules applicable to foreign personal holding company income defined under Code §954(c) with certain exceptions. If either of the entities meets one of the tests described above, a foreign company will be classified as a P.F.I.C. A foreign company cannot be both a C.F.C. and a P.F.I.C. The C.F.C. rule trumps the P.F.I.C. regime.[2] Therefore, if a foreign corporation meets the definition of a C.F.C., it will not be taxed as a P.F.I.C.

A U.S. person will be subject to the P.F.I.C. regime if he or she is a direct or indirect owner of P.F.I.C. shares. This often occurs (i) upon the death of a foreign grantor when his or her revocable trust, taxed as a grantor trust during his or her lifetime, becomes a foreign non-grantor trust or (ii) simply upon the death of a foreign grantor. In some cases, the U.S. person may not even be aware of the existence of such a trust.

For example, stock owned through a corporation or partnership will be attributed to the U.S. person, while stock owned through a foreign trust or a foreign estate is considered to be owned proportionally by its beneficiaries.[3] A disposition of P.F.I.C. stock by the foreign estate or the foreign trust may also be treated as a disposition by a U.S. beneficiary.[4]

If an individual owns a share in a P.F.I.C. either directly or indirectly, the shareholder's holding period begins on the earlier date of the following: (i) the first day that the shareholder owned the stock of the P.F.I.C. directly, or (ii) the first day that the

1 Code §1297(a).

2 Code §1297(d).

3 Code §1296(g)(1).

4 Treas. Reg. §§1.1291-2, 1.1291-3.

shareholder was an indirect owner of the P.F.I.C. stock (or the stock of another preceding P.F.I.C.).

There is some uncertainty in determining a beneficiary's interest in the case of a discretionary trust or a foreign estate prior to final settlement and termination.

If an indirect shareholder is taxable on a disposition of P.F.I.C. shares, he or she will recognize gain equal to the *pro rata* share of the gain the actual owner would have realized on an actual disposition of the stock.

Generally, a direct or indirect owner of a P.F.I.C. may elect to be taxed under one or two of the three P.F.I.C. taxation regimes:

- ***Code §1291 Fund*** – Under this rule, a taxpayer is subject to a punitive tax on "deferred tax amounts" of P.F.I.C. "excess distributions." An excess distribution is the amount by which the shareholder's current year (direct or indirect) distribution exceeds 125% of the average distributions received by the shareholder for the three preceding years. This is the default rule that applies unless the taxpayer makes a timely Qualified Electing Fund ("Q.E.F.") election or Mark-to-Market ("M.T.M.") election.

- ***Q.E.F. Election*** – If a Q.E.F. election is made, the taxpayer will include his or her *pro rata* share of the P.F.I.C.'s ordinary earnings and net capital gains for the year in income on an annual basis. Under this election, loss is not recognized. Generally, this election should be made for the first year of ownership.

- ***M.T.M. Election*** – If an M.T.M. election is made, the taxpayer will include the increased value of the P.F.I.C. shares as ordinary income on an annual basis, to the extent that the fair market value at the end of the year exceeds the taxpayer's basis in the shares. Unlike a Q.E.F. election, losses under an M.T.M. election can be deducted to a certain extent. To make an M.T.M. election, the P.F.I.C. shares must be "marketable" (as discussed in detail below).

REPORTING OBLIGATION

Generally, a U.S. taxpayer with a P.F.I.C. interest has an obligation to file Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Election Fund. This form must be filed every year for each P.F.I.C.

However, there is an exception to the filing obligation for U.S. beneficiaries of a foreign nongrantor trust or foreign estate that owns P.F.I.C. stock and has not made a Q.E.F. or M.T.M. election (unless the beneficiary is treated as receiving an excess distribution from the P.F.I.C. during the beneficiary's taxable year). This is a taxpayer friendly and sensible regulation, as many foreign estate or nongrantor trust beneficiaries do not know or have sufficient information concerning their status.

Filing Form 8621 can be expensive. Therefore, not making an election and waiting to file when the beneficiary receives a distribution can sound tempting. However, the beneficiary should consider the benefits of making an election. If a foreign estate or a foreign trust does not make a distribution for years, the punitive tax regime that accompanies an excess distribution could wipe out significant value of the P.F.I.C. interest.

Q.E.F. ELECTION

One is not required to be a direct owner of P.F.I.C. stock in order to make a Q.E.F. election.[5] Generally, a foreign estate or a foreign trust with a U.S. beneficiary can make an election on Form 8621. If the election is not made at the first level of ownership, the first U.S. owner in the chain of ownership can make the election.

For P.F.I.C. stock to qualify for the Q.E.F. election, a direct or indirect shareholder must comply with complex administrative rules requiring the P.F.I.C. to provide annual accounting statements. Unless the P.F.I.C. is a closely-held family corporation, it is usually difficult for a minority shareholder to obtain this information.

"An excess distribution is the amount by which the shareholder's current year (direct or indirect) distribution exceeds 125% of the average distributions received by the shareholder for the three preceding years."

M.T.M. ELECTION

Similar to the Q.E.F. election, the M.T.M. election can be made by either a direct or indirect owner of the P.F.I.C. This election is made by filing Form 8621 with the applicable tax return or on an amended return, provided that the amended return is filed on or before the election due date.[6]

If the P.F.I.C. stock was acquired by bequest, devise, inheritance, or a decedent's estate, and if an M.T.M. election was in effect as of the date of the decedent's death, then the basis of the P.F.I.C. stock owned by the U.S. beneficiary is the adjusted basis of the stock immediately before the death of the decedent or, if lesser, the basis as determined under Code §1014.[7]

To make an M.T.M. election, the P.F.I.C. stock must be considered a marketable stock. A marketable stock generally is a stock that is regularly traded on a sufficiently regulated exchange.[8]

CONCLUSION

It is important for the U.S. beneficiary to understand the repercussions of direct or indirect ownership of foreign corporations taxed as P.F.I.C.'s. As soon as a beneficiary learns about the P.F.I.C. interest, he or she is advised to consult with a tax professional to determine if it is beneficial (or possible) to make the special elections applicable to P.F.I.C.'s and assess the potential costs of not making these elections.

There are important *de minimis* rules to consider. In general terms, a P.F.I.C. shareholder is not required to file Form 8621 if (i) the aggregate value of the P.F.I.C. stock does not exceed $25,000 ($50,000 when filing a joint tax return) or (ii) the P.F.I.C. is owned indirectly and the value does not exceed $5,000. The *de minimis* exception may not apply if a Q.E.F. or M.T.M. election is made.

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5 Treas. Reg. §1.1295-1(d)(1)

6 Treas. Reg §1.1296-1(h)(1)(i).

7 Code §1296(h)(i).

8 Code §1296(e); Treas. Reg. §1.1296-2.

UPDATES AND OTHER TIDBITS

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S.A.L.T.

I.R.S. ADDRESSES LEGISLATIVE WORKAROUNDS FOR S.A.L.T. DEDUCTION LIMITATIONS

The Tax Cuts and Jobs Act ("T.C.J.A.") placed a $10,000 cap on the amount of state and local tax ("S.A.L.T.") an individual taxpayer can deduct on his or her Federal income tax return. To address this limitation, some states are considering or have already adopted legislative proposals allowing taxpayers to make payments to charitable funds that satisfy certain state purposes (*e.g.*, public education). Those payments would be credited against and thereby reduce a portion of the S.A.L.T. otherwise owed. The objective of these proposals is to allow taxpayers to characterize a payment as a deductible charitable contribution for Federal income tax purposes, as opposed to a payment otherwise subject to the $10,000 cap. In response to these proposals, the I.R.S. recently issued Notice 2018-54 alerting taxpayers that Federal law controls the proper characterization of such payments for Federal income tax purposes. The notice suggested that the I.R.S. will issue regulations addressing the Federal income tax treatment of such transfers, which will be governed by substance over form principles.

PRIVATE EMPLOYEES MAY DEFER INCOME RECOGNITION FROM STOCK OPTIONS

An employee who is granted a nonqualified stock option is required to include the fair market value of the stock (reduced by the price paid, if any) in gross income for the year in which the employee's rights in the stock are vested. The rights in the stock become vested when they are transferable or are not subject to substantial risk of forfeiture, whichever occurs first.

Unlike an employee of a publicly held company who may have tax liability by selling the stock on a readily available stock market, the employee of a closely held company may have to dip into their own pocket to cover the tax liability. This may cause some employees to let the options lapse rather than incur substantial tax liability.

The T.C.J.A. introduced Code §83(i), which allows a qualified employee to defer the income attributable to stock received in connection with the exercise of an option, or in the settlement of a restricted stock unit ("R.S.U.").

If a qualified employee receives such stock and elects application of the new provision, then a taxable event will arise in the year that includes the earliest of the following events:

- The date the qualified stock becomes transferable (including transferable to the employer)
- The date the employee becomes an excluded employee (as explained below)
- The date any stock of the corporation becomes readily tradeable on an established securities market
- Five years after the rights of the employee in the stock are transferable or are not subject to a substantial risk of forfeiture (whichever date is earlier)
- The date the employee revokes the deferral election

The deferral is not available to (i) any employee who currently owns, or in the past ten years had owned, 1% or more of the corporation; (ii) any current or former C.E.O. or C.F.O.; (iii) persons related to the C.E.O. or C.F.O.; or (iv) anyone who is currently, or was in the past ten years, one of the four highest compensated officers of the corporation. Furthermore, the issuing corporation must be closely held at the time of both the issuance of the stock option or R.S.U. and at the time services were performed by the employee. The corporation must also have a written plan under which at least 80% of its U.S. employees are granted stock options.

CRYPTOCURRENCY ACCOUNTING GUIDANCE

In a letter dated May 30, 2018, the American Institute of Certified Public Accountants ("A.I.C.P.A.") urged the I.R.S. to issue a more comprehensive guide on the tax treatment of cryptocurrencies. Generally speaking, the I.R.S. will treat cryptocurrency as "property" per its announcement in Notice 2014-21.[1] The A.I.C.P.A. requested confirmation that charitable contributions of cryptocurrencies greater than $5,000 are treated the same as contributions of publicly traded stock (which do not require a qualified appraisal) and confirmation that cryptocurrencies can be held in retirement accounts. I.R.S. guidance was also requested on acceptable methods for

- valuing and documenting cryptocurrencies,
- computation of capital gains and losses,
- availability of alternative accounting methods,
- availability of the mark-to-market election for qualified dealers and traders,
- installment sales,
- foreign reporting requirements, and
- other reporting matters.

1 For a further discussion of virtual (crypto) currencies see [FK article].

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We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

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The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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