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INSIGHTS

NEW DEVELOPMENTS ON THE E.U. V.A.T. REGIME OF HOLDING COMPANIES

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EDITORS' NOTE

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

- **New Developments on the V.A.T. Regime of Holding Companies.** Like state and local tax in the U.S., where tax exposure can be underestimated by many corporate tax planners, the V.A.T. rules in the E.U. contain many pitfalls. This is especially true when it comes to recovery of V.A.T. input taxes by holding companies. A corporate tax adviser may presume that all V.A.T. input taxes paid by a holding company are recoverable. Yet, despite abundant jurisprudence, debate continues regarding the V.A.T. recovery rights of holding companies. The starting point in the analysis is easy to state. Holding companies that actively manage subsidiaries can recover V.A.T., while holding companies that passively hold shares cannot. The problem is in the application of the theory, where the line between active and passive behavior is blurred by seemingly inconsistent decisions. Bruno Gasparotto and Claire Schmitt of Arendt & Medernach, Luxembourg, explain the rules and how they have been applied by the C.J.E.U.

- **2019 Welcomes New Finnish Interest Deduction Limitations.** Changes to the Finnish interest barrier regime have come into effect in 2019. They have been expected since 2016, when the E.U. released its Anti-Tax Avoidance Directive ("A.T.A.D."), which sets forth the minimum standards for interest deduction restrictions within the E.U. The limitations affect E.B.I.T.D.A.-based rules (*i.e.*, addressing earnings before interest, tax, depreciation, and amortization) adopted in 2014, which include the specific interest barrier rule affecting the deductibility of intra-group interest payments. Antti Lehtimaja and Sanna Lindqvist of Krogerus Ltd., Helsinki, explain the key elements of the new restrictions, including some considerations regarding the impact on Finnish taxpayers and investments in Finland.

- **I.R.S. Issues Additional Guidance on New Opportunity Zone Funds.** Days after Galia Antebi and Nina Krauthamer published "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit," the I.R.S. issued guidance in proposed regulations. Now, in a follow-up article, Galia Antebi and Nina Krauthamer focus on the new guidance as it relates to the deferral election and the Qualified Opportunity Zone Fund. In particular, they address (i) which taxpayers are eligible to make the deferral election, (ii) the gains eligible for deferral, (iii) the measurement of the 180-day limitation, (iv) the tax attributes of deferred gains, and (v) the effect of an expiration of a qualifying zone status on the step-up in basis to fair market value after ten years.

- **Code §962 Election: One or Two Levels of Taxation?** Code §962 allows an Individual U.S. Shareholder to apply corporate tax rates and offers relief from double taxation in certain situations, but where new provisions of the Tax Cuts & Jobs Act ("T.C.J.A.") are involved, the application is murky. The T.C.J.A. introduced two provisions designed to limit the scope of deferral for the earnings of foreign subsidiaries operating abroad. One provision is the one-time deemed repatriation tax regime of Code §965, which looks backward to tax what had been permanently deferred earnings. The other provision is the global intangible low taxed income ("G.I.L.T.I.") regime, which eliminates most deferral on a go-forward basis. Each provision limits deferral but, at the same time, imposes relatively benign tax on U.S.-based multinationals. Interestingly, it seems that it was only in the last days of the legislative process that Congress became aware that owner-managed businesses also operate abroad. While the provisions clearly apply to corporations, Congress may or may not have provided a benefit for the U.S. individuals who own of these companies. Sound cryptic? Fanny Karaman and Nina Krauthamer explain all.

- **Attorney-Client Privilege Extends to Accountants Retained by Legal Counsel.** Over time, the attorney-client privilege, which protects information disclosed by a client, has been extended to include certain client communications to accountants retained by legal counsel to provide input regarding the application of accounting rules. However, the privilege does not apply when a client retains the accountant prepare tax returns. In *U.S. v. Adams*, the I.R.S. challenged the extension of the privilege to an accountant who provided advice to the client's defense counsel and later prepared U.S. tax returns for the client. The decision likely satisfies neither the I.R.S. nor the taxpayer. Rusudan Shervashidze and Stanley C. Ruchelman explain the I.R.S. challenge and the Solomon-like solution reached by the court.

- **I.R.S. Adds New Issues of Focus for Cross-Border Audits.** In late 2018, LB&I announced five additional campaigns aimed at determining whether taxpayers are complying with tax rules in the following areas of the law: (i) foreign tax credits claimed by U.S. individuals, (ii) offshore service providers that assist taxpayers in creating foreign entities and tiered structures to conceal the U.S. beneficial ownership of foreign financial accounts, (iii) F.A.T.C.A. compliance by F.F.I.'s and N.F.F.E.'s, (iv) tax return compliance by foreign corporations that ignore the fact that they are engaged in a U.S. trade or business under the rules of U.S. tax law, and (v) late issuance of Work Opportunity Tax Credit ("W.O.T.C.") certifications that result in the need to file amended tax returns and result in a misuse of I.R.S. resources when returns are filed without the W.O.T.C certifications. The move follows more than two years, of I.R.S. publications that alert the public to certain issue-based approaches being followed by examiners. Galia Antebi and Elizabeth V. Zanet summarize the new releases.

- **Mirror, Mirror, On the Wall, Which Is My Tax Home of Them All? – Foreign Students Face Dilemma in the U.S.** The U.S. Department of State administers the Exchange Visitor Program, which designates sponsors to provide foreign nationals with opportunities to participate in educational and cultural programs in the U.S. and return home to share their experiences. These students receive taxable stipends, file tax returns, and reduce taxable income by costs associated with participation. Unfortunately, a recent Tax Court case, *Liljeberg v. Commr.*, has determined that the travel and lodging costs of these individuals could not be deducted. Neha Rastogi and Beate Erwin explain that while home is where the heart is, a "tax home" is where a person is expected to live when taking into consideration the individual's principal place of employment.

- **Updates and Other Tidbits.** This month, Rusudan Shervashidze and Stanley C. Ruchelman look at several interesting items, including (i) the publication of draft legislation by the Crown Dependencies of Guernsey, Jersey, and Isle of Man calling for the existence of economic substance for resident companies engaged in certain businesses and defining what that means, (ii) the denial of benefits incident to foreign earned income for a military contractor in Afghanistan who maintained a place of abode in the U.S., (iii) an increase in fees charged by the I.R.S. to issue residency certificates, (iv) the establishment of a working group to combat transnational tax crime through increased enforcement collaboration among tax authorities in several countries, and (v) changes to China's residency rules and the sharing of taxpayer financial information under C.R.S.

We hope you enjoy this issue.

- The Editors

NEW DEVELOPMENTS ON THE E.U. V.A.T. REGIME OF HOLDING COMPANIES

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Tags
C.J.E.U.
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INTRODUCTION

It may come as a surprise to some that the European value added tax ("V.A.T.") regime applicable to holding companies is not supported by dedicated provisions in Directive 2006/112/EC (the "V.A.T. Directive"), which rules the European V.A.T. system. Instead, the V.A.T. regime for holding companies is ruled by numerous decisions issued by the Court of Justice of the European Union ("C.J.E.U.").

Through its interpretation of the V.A.T. Directive provisions, the C.J.E.U. has outlined the main features of the regime for holding companies in an attempt to harmonize treatment within the E.U.

Despite the abundant jurisprudence, debate continues to surround the V.A.T. recovery rights of holding companies, as evidenced by three recent C.J.E.U.'s decisions issued in 2018.

In this evolving context, it is worthwhile to recall the main features of the V.A.T. regime laid out in the V.A.T. Directive and their application to holding companies in light of new case law – with the caveat that the following does not constitute an exhaustive list of all C.J.E.U. decisions but addresses the main ones relating to V.A.T. recovery rights.

DISTINCTION BETWEEN PASSIVE AND ACTIVE HOLDING COMPANIES

An important feature of the V.A.T. regime is the distinction between "passive" and "active" holding companies. This distinction is based on the notion of economic activity for V.A.T. purposes.

The scope of the E.U. V.A.T. rules depends on whether a person is engaged in an economic activity, which is defined under Article 9, §1 of the V.A.T. Directive in the following terms:

> Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, shall be regarded as 'economic activity.' The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity.

In line with this criterion, the C.J.E.U. has specified that the mere holding of shares without any involvement in the management of the subsidiaries cannot be assimilated to the exploitation of intangible property, and as such, any resulting dividends are merely the product of passive ownership.[1]

Such holdings do not amount to economic activity, and therefore, passive holding companies do not qualify as taxable persons for V.A.T. purposes. This qualification has multiple consequences:

- The receipt of dividends does not fall within the scope of V.A.T.
- Passive holding companies lack the right to recover input V.A.T.
- Passive holding companies are exempt from any V.A.T. compliance obligations, such as V.A.T. registration and V.A.T. returns, subject to exceptions.

The same cannot be said for active holding companies. Indeed, the C.J.E.U. takes a distinct approach when the holding company is directly or indirectly involved in the management of its subsidiaries, for example, by supplying administrative, accounting, or I.T. services to subsidiaries.

From a general perspective and based on consistent C.J.E.U. case law,[2] once a holding company provides a taxable service to its subsidiary in exchange for consideration, it is deemed to perform a taxable economic activity and therefore qualifies as a taxable person for V.A.T. purposes.

This qualification opens the right to recover input V.A.T. Indeed, since it performs taxable activities for V.A.T. purposes, an active holding company may deduct the input V.A.T. incurred on its costs, a cornerstone of the V.A.T. system.

"Since it performs taxable activities for V.A.T. purposes, an active holding company may deduct the input V.A.T. incurred on its costs."

The resulting question is whether the V.A.T. deduction right is full or only partial and, subsequently, under which conditions the right should be exercised. During the last ten years, these complex questions have been largely unanswered and regularly put on the table of the C.J.E.U.

EXERCISING THE V.A.T. DEDUCTION RIGHT

General Provisions on the V.A.T. Deduction Right

As a general principle, any person engaged in taxable activities is entitled to deduct input V.A.T. paid for costs incurred in relation to this activity per Article 168 of the V.A.T. Directive.

As laid out in the V.A.T. Directive and frequently reiterated in C.J.E.U. decisions,[3] this recovery right is meant to relieve the trader entirely from the burden of V.A.T. in the course of its economic activities. Only the end-consumer should bear such charge. This constitutes an integral part of the V.A.T. scheme.

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1 C.J.E.U., 06/20/1991, *Polysar* Investments *Netherlands BV v Inspecteur der Invoerrechten en Accijnzen*, C-60/90; C.J.E.U., 06/22/1993, *Sofitam S.A.*, C-333/91.

2 C.J.E.U., 11/14/2000, *Floridienne S.A. and Berginvest S.V. v Belgian State*, C-142/99; C.J.E.U., 07/12/2001, *Welthgrove BV v Staatssecretaris van Financien*, C-102/00.

3 For instance, C.J.E.U., 02/14/1985, *Rompelman*, C-268/83.

While this principle appears relatively simple to implement with respect to commercial companies engaged in economic activities, the application of the V.A.T. deduction right in the context of active holding companies is more difficult to assess.

Since active holding companies qualify as taxable persons as a result of their involvement in their subsidiaries, they might be engaged in three types of activities from a V.A.T. perspective:

- Activities falling outside the scope of V.A.T.
- Activities falling within the scope of V.A.T. but that are V.A.T.-exempt
- Activities falling within the scope of V.A.T. that are fully taxable

In this context, the regular rules for exercising the V.A.T. deduction right[4] do not quite seem appropriate. While, in principle, the above-mentioned V.A.T. provisions only consider the performance of economic activities when assessing the right to deduct V.A.T., the role of the shareholding activity can hardly be ignored for active holding companies.

The other resulting question is to what extent this non-economic activity should be taken into account, bearing in mind that dividends might constitute significant income without necessarily being cost-consuming. On the other hand, the costs subject to the V.A.T. recovery claim could constitute a significant amount compared to the income generated from the taxable activity.

This mismatch has been notably addressed by Mrs. Juliane Kokott, Advocate General ("A.G."), in an opinion delivered on May 3, 2018, in the *Ryanair* case:

> A simple comparison of the values of the turnover from management services and from dividends neglects the fact that the holding of shares does not give rise to recurrent costs. Furthermore, the input tax surplus described above also exists only in the taxation period in which the acquisition of shares of a company occurs. If the management services are supplied for remuneration over a number of years, the situation is different.[5]

Consequently, this calls the determination of the input V.A.T. recovery right into question with respect to the allocation of costs incurred per activity performed.

C.J.E.U. General Principles for Determining V.A.T. Recovery Rights

The abundant C.J.E.U. jurisprudence establishes general guidelines for the allocation of costs to activities of the holding company:

- **Direct Allocation:** V.A.T. recovery is available for input transactions that are subject to V.A.T. and that have a direct and immediate link with one or more output transactions giving rise to the right to deduct. This condition is fulfilled when the expenditure is a component of the price of the output transaction that gives rise to the right to deduct.

[4] Article 167 et seq. of the V.A.T. Directive.

[5] C.J.E.U., 10/17/2018, *Ryanair Ltd v. The Revenue Commissioners*, C-249/17, §30.

- **Overhead Costs:** Where the expenditure cannot be directly allocated to a specific output transaction, the treatment depends on whether the costs incurred were part of the general expenses linked to the taxable person's overall economic activities. In this situation, the expenditure will have, in principle, a direct and immediate link with the taxable person's business as a whole. Depending on the nature of the business, the related V.A.T. deduction will be (i) full (in the case of a fully taxable business), (ii) zero (in the case of a fully V.A.T.-exempt business), or (iii) partial (in the case of a combination of both taxable and V.A.T.-exempt activities).

In theory, these guidelines easily outline the V.A.T. recovery rights of active holding companies. However, their practical application raises many questions about the integration of the non-economic activity (*i.e.*, shareholding activity) in the calculation of deductible input V.A.T., leading to discrepancies among Member States and, consequently, to questions of prejudice being placed before the C.J.E.U.

DETERMINING V.A.T. RECOVERY RIGHTS IN SPECIFIC SITUATIONS

V.A.T. Deduction for Expenditures Incurred in a Shareholding Acquisition

V.A.T. Deduction for Expenditures for the Acquisition of a Shareholding (C.J.E.U., 09/27/2001, Cibo Participations, C-16/00)

Cibo Participations placed the first question before the C.J.E.U. concerning the deduction right for general expenditures incurred in the context of an acquisition of shares in an entity to which the holding company will supply taxable services.

According to the C.J.E.U., it is clear that the direct allocation method cannot be used in such context since no direct and immediate link can be drawn between the various costs incurred in the acquisition and a specific output transaction.[6] However, such costs can be considered general expenditures, which have a direct and immediate link with the overall activity of the taxable person.

Where the overall activity includes output transactions entitled and also not entitled to a V.A.T. recovery right (*i.e.*, a mix of taxable and V.A.T.-exempt activities), costs should be apportioned between these two activities, and only the portion related to output transactions entitled to a V.A.T. recovery right should benefit.

In other words, when costs qualify as general expenditures, they are linked to the overall activities of the taxable person and, in the case of mixed activities, an apportionment should be made to determine the *pro rata* deduction.

In this respect, the C.J.E.U. enunciated the following rule:

> Expenditure incurred by a holding company in respect of the various services which it purchases in connection with the acquisition of a shareholding in a subsidiary forms part of its general costs and therefore has, in principle, a direct and immediate link with its business as

[6] C.J.E.U., 09/27/2001, *Cibo Participations*, C-16/00.

> a whole. Thus, if the holding company carries out both transactions in respect of which value added tax is deductible and transactions in respect of which it is not, it follows . . . that it may deduct only that proportion of the value added tax which is attributable to the former.

Apportionment of Expenditures Based on Involvement in the Management of Subsidiaries (C.J.E.U., 07/16/2015, Larentia + Minerva, C-108/14 and C-109/14)

In *Larentia + Minerva*, the C.J.E.U. distinguished the situation in which a holding company manages all subsidiaries from a fact pattern in which only certain subsidiaries were managed by the holding company:

> The expenditure connected with the acquisition of shareholdings in subsidiaries incurred by a holding company which involves itself in their management and which, on that basis, carries out an economic activity must be regarded as belonging to its general expenditure[,] and the VAT paid on that expenditure must, in principle, be deducted in full, unless certain output economic transactions are exempt from VAT.
>
> * * *
>
> The expenditure connected with the acquisition of shareholdings in subsidiaries incurred by a holding company which involves itself in the management only of some of those subsidiaries and which, with regard to the others, does not, by contrast, carry out an economic activity must be regarded as only partially belonging to its general expenditure, so that the VAT paid on that expenditure may be deducted only in proportion to that which is inherent to the economic activity, according to the criteria for apportioning defined by the Member States, which when exercising that power, must . . . provide for a method of calculation which objectively reflects the part of the input expenditure actually to be attributed, respectively, to economic and to non-economic activity.

Broad Definition of Involvement in the Management of Subsidiaries (C.J.E.U., 07/05/2018, Marle Participations, C-320/17)

In a recent C.J.E.U. case, *Marle Participations*, the court clarified the concept of involvement in the management of subsidiaries and the conditions for exercising the right to claim input V.A.T. deduction for holding companies.

As previously stated, involvement in the management of subsidiaries is crucial for holding companies to claim input V.A.T. deductions because it qualifies the entity as active and therefore as a taxable person for V.A.T. purposes. If a holding company provides taxable services to its subsidiary, it automatically qualifies as a taxable person, irrespective of the nature of the services supplied. Traditionally, this referred to the supply of administrative, financial, commercial, and technical services and was therefore understood to be restrictive.

However, the C.J.E.U. ruling in *Marle Participations* broadened the scope to include the mere lease of a building to its subsidiary, provided the rent is subject to V.A.T. and the premises are regularly supplied to the subsidiary. Occasional supplies are excluded from favorable treatment. Following this ruling, involvement is defined broadly as covering any service supplied to a subsidiary provided it is subject to V.A.T.

In regard to the input V.A.T. recovery right, the C.J.E.U. considers a cost to be linked to a shareholding acquisition even if the cost does not have a direct and immediate link to an output transaction. Indirect and deferred output transactions are considered linked to the overall economic activities of the active holding, *i.e.*, excluding the shareholding activity. The apportionment of costs linked to the shareholding activity applies only when the holding company is not involved in the management of all its subsidiaries. In *Marle Participations*, the C.J.E.U. ruled that the V.A.T. Directive would no longer be used to determine the scope of the input V.A.T. recovery right, such as mandating a *pro rata* deduction of costs. Instead, Member States may determine an appropriate allocation key in accordance with the general principles of the V.A.T. system.

"Member States may determine an appropriate allocation key in accordance with the general principles of the V.A.T. system."

Considering these three decisions, the position of the C.J.E.U. seems quite favorable regarding the recovery right for input V.A.T. for general expenditures incurred by an active holding company in the context of a shareholding acquisition, subject to the conditions mentioned.

V.A.T. Deduction for Abort Costs (C.J.E.U., 10/17/2018, Ryanair Ltd, C-249/17)

The C.J.E.U. issued another welcome decision for active holding companies regarding abort costs (*e.g.*, legal or due diligence costs) linked to an unsuccessful bid to take over shares of a competitor.

In regard to the qualification as a taxable person, the C.J.E.U. considers that the mere intention to supply management services to the intended target company constitutes preparatory acts for a taxable activity and therefore is sufficient to qualify the holding company as a taxable person at the time of incurring the abort costs. In addition, abort costs incurred in this context qualify as overhead costs linked to the economic activities of the holding company. Accordingly, the related input V.A.T. will be fully deductible in light of the intended taxable activity, even if not realized in the end.

This decision is in line with previous E.C.J. decisions and seems to confirm a favorable trend of access to the V.A.T. recovery right in the context of shareholding acquisition (even unsuccessful).

Limitation of the V.A.T. Deduction for General Expenditures for the Issuance of Shares (C.J.E.U., 03/13/2008, Securenta, C-437/06)

In regard to costs incurred in the context of the issuance of shares, the C.J.E.U. took a different approach while relying on the principles outlined above.

Although their qualification as overhead costs was not questioned, the C.J.E.U. ruled that the issuance of shares is linked to non-economic activity, *i.e.*, shareholding. In line with prior rulings, overhead costs must be linked with general activities of the active holding company, *i.e.,* economic and non-economic. Consequently, the input V.A.T. deduction right should be apportioned to the economic and non-economic activities. However, the C.J.E.U. left the determination of apportionment between these two activities to the discretion of the Member States.

V.A.T. Deduction for Expenditures Incurred in a Share Disposal

V.A.T. Recovery for Expenditures Incurred in a Share Disposal (C.J.E.U., 04/06/1995, BLP, C-4/94)

In *BLP*, the C.J.E.U. adopted a restrictive approach with regard to the input V.A.T. recovery right for expenditures linked to a share disposal. The company in question incurred various legal, accounting, and banking costs in relation to a sale of shares carried out to meet liquidity needs – funds from the disposal of one subsidiary were to be used to finance the provision of management services to other subsidiaries.

The C.J.E.U. held that the transaction carried out by the holding company was the sale of shares of a subsidiary. That activity was exempt from V.A.T. Consequently, there was no cost incurred to carry out a trade in whole or in part and no input V.A.T. was incurred. In addition, the costs incurred contained no direct and immediate link to a taxable output transaction. Hence, no input V.A.T. deduction right could be granted.

As is apparent, the approach of the C.J.E.U. in *BLP* was far more restrictive with respect to share purchase transactions.

V.A.T. Recovery for General Expenditures Incurred in a Share Disposal (C.J.E.U., 10/29/2009, AB SKF, C-29/08)

In *AB SKF*, the C.J.E.U. later took a less restrictive approach in a similar context.

Following *AB SKF*, the C.J.E.U. makes a distinction between costs directly allocated to an output transaction, *i.e.*, the sale of shares, and general costs not allocated to a particular output transaction. Costs incurred to sell shares are components of the price of the shares to be sold. Where they are not incorporated in the price, they constitute overhead costs and therefore have a direct and immediate link with the taxable person's economic activity as a whole.

Costs not allocated to a particular output transaction do not require apportionment between economic and non-economic activities. As to these costs, the C.J.E.U. adopted a taxpayer-friendly approach:

> The costs of the services in question are part of his general costs and are, as such, components of the price of the goods or services which he supplies. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole.[7]

This applies regardless of the V.A.T. treatment applicable to the disposal of shares, where the transaction is V.A.T.-exempt or falling outside the scope of V.A.T. For these costs, the input V.A.T. deduction right is largely available to active holding companies.

V.A.T. Recovery for Expenditures Incurred in a Share Disposal of a Managed Subsidiary (C.J.E.U., 11/08/2018, C&D Foods Acquisition, C-502/17)

The decision in *C&D Foods Acquisition* claws back the scope of the decision in *AB SKF*. In *C&D Foods Acquisition*, the C.J.E.U. ruled that a sale of shares, in itself, does not constitute an economic activity, implying that no deduction of input V.A.T.

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[7] C.J.E.U., 04/06/1995, *BLP*, C-4/94, para. 58.

on related costs can be granted. Thus, it seems to adopt the holding in *BLP*. However, the case goes on to say that, if the direct and exclusive reason for the share sale relates to the taxable activity of the parent company, or constitutes a direct, permanent, and necessary extension of the parent company's taxable activity, a V.A.T. deduction right may be recognized. This would be the case if a sale of shares is carried out with the purpose of allocating the proceeds directly to the taxable activity of the parent company or to the economic activity carried out by the group of which it is the parent company. In substance, this suggests that the favorable ruling in *SKF* should be an exception to the general rule of *BLP*.

In sum, a deduction on share disposal costs is now possible in specific circumstances demonstrating that the underlying purpose of the transaction causes the share disposal to be directly and exclusively linked to a taxable activity. If so, an active holding company may be entitled to a V.A.T. recovery right on share disposal costs. While it may be easy to state the rule, the application may not be clear at all. What facts must exist to demonstrate that the purpose of the transaction meets the test of *C&D Foods Acquisition*? Certainly, detailed legal documentation relating to the objective of the divestment of shares might serve to support V.A.T. recovery on the connected costs. However, if no business records kept in the ordinary course of business by operating personnel address a business goal of the transaction, mere legal documents prepared by savvy lawyers may not suffice to justify V.A.T. recovery.

CONCLUSION

These numerous developments highlight the difficulty of establishing clear guidelines for determining the V.A.T. recovery right of active holding companies, particularly the apportionment between economic and non-economic activities.

Despite the guidance provided by the C.J.E.U., room for interpretation still exists and different approaches can be found among the Member States. In this context, it can be expected that questions will continue to be referred to the C.J.E.U. where the final decision may be based on the quality of the advocacy rather than well thought through policy.

2019 WELCOMES NEW FINNISH INTEREST DEDUCTION LIMITATIONS

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The long-awaited Finnish government proposal[1] concerning new interest limitation rules was published on September 27, 2018. The Finnish parliament responded[2] on December 4, 2018, calling for certain minor changes and accepting the amendment into law. The new limitations took effect as of the beginning of 2019.

BACKGROUND

Before the tax year 2014, only the general anti-avoidance rule ("G.A.A.R.") and transfer pricing adjustments were potentially available to challenge interest deductions in Finland. The tax authorities rarely challenged an interest expense deduction, even in fairly aggressively-leveraged situations.

Following the lead of other European countries, Finland adopted specific E.B.I.T.D.-based rules (*i.e.*, addressing earnings before interest, tax, depreciation[3]) to be applicable in the tax year 2014. Since then, Finland has benefited from a specific interest barrier rule, applicable in both domestic and international situations, affecting the deductibility of intra-group interest payments.

Changes to the Finnish interest barrier regime have been expected since 2016, following the publication of the E.U. Anti-Tax Avoidance Directive[4] ("A.T.A.D."), which sets forth the minimum standards for interest deduction restrictions within the E.U. A.T.A.D. implemented the recommendations set in the O.E.C.D. B.E.P.S. Project, which aims to prevent tax avoidance strategies that exploit gaps and mismatches in tax rules and attempts to find common international rules for combating inappropriate tax avoidance.

The O.E.C.D. countries have been concerned about corporations using debt financing to transfer taxable income to countries that have lower tax rates. The specific recommendations involving interest deductions and other financial payments are included in the B.E.P.S. Action 4.[5]

This article discusses the key elements of the new Finnish interest deduction restrictions, including a brief description of the new rules and some key considerations regarding their impact on Finnish taxpayers and investments in Finland.

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1 Government Proposal HE 150/2018 vp.

2 Response by the Parliament EV 146/2018.

3 The Finnish interest barrier rule does actually not include adjustments for amortizations.

4 Council Directive (E.U.) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

5 The B.E.P.S. Actions can be found on the O.E.C.D. website. Action 4 was published in 2015 and was updated in 2016.

INTEREST DEDUCTION RULES IN A NUTSHELL

Compared to the old rules, the new rules included in sections 18a and 18b of the Finnish Business Income Tax Act[6] have a broader scope, mainly in two ways:

- With certain exceptions, the new regime will generally apply to all Finnish-resident corporate taxpayers and partnerships, *i.e.*, not only entities that are deemed to carry on business activities but also other entities. In practice, this means a significant change especially for the Finnish real estate sector, since real estate companies and mutual real estate companies ("M.R.E.C.'s") have, in most cases, fallen outside the scope of the old interest barrier regime.
- Unlike the old restrictions, A.T.A.D. requires the new regime to be applied to all interest expenses, whether paid to a related or unrelated party. Interest payable on a bank loan can also become nondeductible if the amount of interest is high enough to disqualify it from exemptions.

Like the old rules, the new rules include several levels of restrictions and exemptions, which are described below. In that regard, the structures of the old and new regimes are similar.

De Minimis Threshold

The first limitation rule is that if the amount of the company's total net interest payments (*i.e.*, interest expenses less interest income) do not exceed €500,000, the entire amount of net interest expense generally is deductible. The same minimum level existed in the old regime.

It should be noted that the €500,000 threshold is lower than its counterpart under A.T.A.D., which is set at net interest payments of €3 million. This stricter approach reflects the Finnish government's view that goal of implementing A.T.A.D. was not to increase allowable deductions under Finnish law in this regard. Thus, the principal of A.T.A.D. was adopted, but the threshold level for imposing restrictions on deductions remained unchanged.

"When the net interest expense exceeds €500,000, the deduction is capped at 25% of the adjusted taxable profit."

Once the net interest payments exceed the threshold, the following rules apply.

Tax-E.B.I.T.D. Rule

When the net interest expense exceeds €500,000, the deduction is capped at 25% of the adjusted taxable profit ("Tax-E.B.I.T.D.").

Tax-E.B.I.T.D. is calculated by employing the following steps:

1. Starting with the taxable net profit or loss figure, interest expense and tax depreciation are added back into income.
2. Then, any group contributions[7] from affiliates are also added into income.

[6] The Finnish Business Income Tax Act (*laki elinkeinotulon verottamisesta*) 360/1968, as amended.

[7] In absence of a group taxation system or an unlimited consolidation of taxable profits within a group, contributions are the sole opportunity, under Finnish law, to balance taxable profits and losses among Finnish entities in a group. Fairly strict criteria are set for granting group contributions.

3. Finally, group contributions to affiliates are deducted from income.

The Tax-E.B.I.T.D. rule predates the new regime. Under A.T.A.D., deductions could account for up to 30% of E.B.I.T.D. However, Finland has chosen to maintain the preexisting 25% limit.

In practice, the Tax-E.B.I.T.D. rule means that large amounts of interest expense can be deductible if a company is sufficiently profitable.

Safe Harbor for Third-Party Loan Interest Expenses

As mentioned above, pursuant to A.T.A.D., interest barrier rules must apply to third-party interest as well as to related-party interest expense. However, the risk of aggressive tax planning involving interest expense has generally been associated with group related parties. Therefore, in the new Finnish regime it was deemed appropriate to provide more lenient regulations for interest payable to third parties.

If the Tax-E.B.I.T.D. rule would otherwise cap the deduction for interest expense, significant relief remains available for interest payable to parties other than group related parties: Net interest payable to third parties will be deductible up to a cap of €3 million. In comparison to the €500,000 limit, the €3 million limit is a safe harbor rule. Even in cases where the net interest expense payable to parties other than group related parties exceeds €3 million, this amount is always deductible. Further explanation of group related parties appears below.

Balance Sheet Exemption

In cases where the interest ceiling is problematic, notwithstanding the three steps mentioned above, there is still a possibility of avoiding the loss of deductions under the cap.

Finnish tax law provides a balance sheet exemption under which a Finnish company, having a lower debt-to-equity ratio on a separate company basis than the group ratio computed on a consolidated basis, is allowed to deduct the interest expenses that would otherwise be nondeductible. A Finnish entity that has a debt-to-equity ratio that is lower than the consolidated ratio for its group has a greater percentage of its assets funded by equity than the group as a whole. In that set of circumstances, net interest expense of the Finnish company is not viewed to be abusive.

The balance sheet exemption has been extremely beneficial for taxpayers. In 2016, 190 Finnish companies were subject to the interest deduction limitation. The total non-deductible interest expense of all 190 companies amounted to €550 million. The same year, 59 companies were eligible for the balance sheet exemption. This enabled those companies to save a total of €215 million in the aggregate of deductible interest expense, a relatively large amount compared to the aggregate catch of the interest restrictions in that year.[8]

With slight modifications, the balance sheet exemption under current law existed under the old interest barrier restrictions. Under the exemption, the parent of the group must be based in a Member State of the E.U. or the E.E.A., or in a country with which Finland has an income tax treaty in force. In addition, the balance sheets must be prepared in accordance with the I.F.R.S. or legislation applicable in an

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8 Government proposal 150/2018, chapter 2.4.2.

E.U. or E.E.A. country, or in accordance with comparable standards such as U.S. G.A.A.P.

The new rule requires that both the individual company balance sheet and the group balance sheet be prepared in accordance with the same set of accounting principles. If the Finnish company's set of accounts is prepared under I.F.R.S. and the group's consolidated set of accounts is prepared under U.S. G.A.A.P., a reconciliation of one set of accounts can be prepared (either way) so that the computation of the debt-to-equity ratios of the company and the group can be made under the same set of accounting rules.

The balance sheet exemption has been subject to case law regarding the scope of its application. For example, in several cases, the Supreme Administrative Court ruled that only the ultimate group balance sheet may be used in the comparison – not a balance sheet of a sub-group parent company.

GROUP RELATED PARTIES

As explained above, only third-party loan interest may benefit from the €3 million safe harbor rule. In comparison, interest paid on Group Related Party loans may qualify only for the general €500,000 and 25% of Tax-E.B.I.T.D. exemptions. The treatment of the latter is the same as under the old interest barrier rules. However, in the new interest barrier regime, the term is changed from *etuyhteysyritys* (which could be translated as "Related Party") to *konserniyhteydessä oleva osapuoli* (here, we use the term "Group Related Party").

As under prior law, the definition of Group Related Party is the same as the domestic law definition of related parties for transfer pricing purposes found in section 31.2 of the Finnish Act on Taxation Procedures.[9] However, Group Related Party is separate from the definition of Associated Enterprise used in A.T.A.D. when determining exempted Standalone Entities, which are explained below.

The parties are considered group related parties if one party has control over the other party or a third-party, alone or together with associated parties, has control over both parties to the loan transaction.

A party has control over the other party when

- it directly or indirectly holds more than half of the equity of the other party;
- it directly or indirectly holds more than half of the voting rights in the other party;
- it has directly or indirectly the right to appoint more than half of the members of the board of directors or other comparable bodies (or a body having the right to appoint the members in the foregoing) in the other party; or
- it is managed jointly with the other party or it may otherwise *de facto* use control in the other party.

Even though bank loans normally qualify as third-party loans, a bank loan may be recharacterized as Group Related Party debt in back-to-back situations.

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9 The Finnish Act on Taxation Procedures (*laki verotusmenettelystä*) 1558/1995, as amended.

A more complex rule applies when a receivable owned by a Group Related Party is pledged to secure a third-party loan. To the extent of the pledge, the third-party loan is "contaminated" as a Group Related Party loan. In practice, the lender might forego taking a security interest in the receivable in order to enable the borrower to benefit from an interest expense deduction, thereby reducing its tax, which frees up additional funds to service the loan.

ITEMS INCLUDED AS INTEREST

Finnish tax legislation does not include a general definition of interest. Treatment as interest is generally based on case law and general tax practice. Usually, items that compensate the lender for allowing a borrower to use of the borrowed funds are considered to be interest.

To comply with A.T.A.D., the new law includes a specific definition of interest income and expense for purposes of the interest barrier rule. In addition to compensation for the use of debt financing, the definition also covers all expenses incurred in connection with the raising of debt financing. Interest expense and interest income are defined symmetrically.

A.T.A.D. includes an example list of payments that could be considered interest payments. The Finnish government proposal included additional views on which items should be considered interest for Finnish tax purposes:

- Payments under profit participating loans
- (Imputed) interest on zero coupon bonds
- Interest on capital loans, certain interest expenses which are capitalized
- Any interest amount which has been adjusted based on transfer pricing rules

As stated above, expenses incurred in connection with the raising of debt financing will also be considered interest under the new regime. Examples include the following:

- Guarantee fees and fees for granting security
- Arrangement fees and other non-recurring expenses charged in connection with raising debt financing
- Fees for changing loan terms or for premature repayment

The new rules will not affect the tax treatment of expenses from equity financing, such as initial public offerings. In addition, the following items are not considered interest:

- The interest component in a finance lease
- Amounts payable under interest derivatives (*e.g.*, payments based on interest rate swaps)
- Foreign exchange losses

Payments for services that do not constitute a fee for arranging debt financing are not regarded as interest expense even if they are somewhat connected to the debt.

Thus, for example, an advisor's fee for planning the structure of the debt financing transaction is not considered interest expense.

Financing charges payable by shareholders to M.R.E.C.'s will not fall under the definition of interest (even though, *de facto*, these payments may contain taxable components based on the interest payable by the M.R.E.C. to the bank). An M.R.E.C. is a special type of Finnish limited liability company. The M.R.E.C. owns the underlying real estate assets, but under the articles of association, the owners of the M.R.E.C. are entitled to possess the specified premises or real estate. Consequently, if the premises are leased, the owners of the company will directly receive the rental income. As the M.R.E.C. nevertheless incurs costs (*e.g.*, due to acquisition and ownership of the real estate), the owners must pay maintenance charges and financing charges to the company to cover its costs.

"Finland has chosen to utilize the possibility to exclude Standalone Entities from the scope of the interest barrier rules."

CARRY FORWARD OF NONDEDUCTIBLE INTEREST EXPENSES

Nondeductible interest expenses continue to be carried forward indefinitely. Also, in the case of a merger or demerger, the nondeductible part of the interest expense will be transferred. However, the nondeductible net interest expense from previous years may not be deducted beyond the limit that is computed for the current fiscal year.

Nondeductible net interest expense should be monitored separately with regard to loans to group related parties and other parties. In addition, if the Finnish entity has another source of income in addition to its business, the non-deductible interest amounts should be allocated to different income baskets, as set out in the law.

Thus, maintaining the "tax asset" for the future requires some administrative work.

EXEMPTIONS

While the scope of the interest barrier rules is broad, some companies remain fully exempt from the restrictions:

Standalone Entities

A.T.A.D. introduces a new definition of "Standalone Entities" (*itsenäinen yritys*), which are exempt from the restrictions based on the assumption that there is lower risk of tax avoidance in such entities. Finland has chosen to utilize the possibility to exclude Standalone Entities from the scope of the interest barrier rules.

A Standalone Entity is an entity that is not part of a consolidated group, does not have a permanent establishment abroad, and is not directly or indirectly entitled to more than 25% of the voting rights, capital, or profits of another entity (or vice versa). Moreover, no entity or natural person has a share of at least 25% in both the entity in question and another entity.

The definition of a Standalone Entity is new to Finnish legislation, and as noted above, it is not the same as a non-Group Related Party. For example, many Finnish residential housing companies will be exempt from the interest barrier rules as Standalone Entities due to their broad ownership base.

Financial Undertakings

The old Finnish interest barrier rules already included an exemption for companies engaged in the financial sector. In implementing A.T.A.D., Finland chose to align the definition to correspond with the definition of "Financial Undertaking" set out in A.T.A.D. in order to avoid any potential claims of illegal State Aid prohibited under E.U. law.

The new law explicitly lists the Financial Undertakings that are fully exempt from the restrictions. Compared to the old law, the definition is broader in certain parts and narrower in other parts. The following Financial Undertakings are exempt under the new regime:

- Credit institutions
- Investment firms
- Alternative investment funds and their managers
- Undertakings for a collective investment in transferable securities and their management companies
- Insurance companies

Certain Long-Term Public Infrastructure Projects

Finland has chosen to implement an A.T.A.D. exemption for certain long-term public infrastructure projects. The old interest barrier rules did not contain such an exemption.

As the current Finnish system for government-supported social housing production was already "approved" as compliant with the E.U. State Aid rules, it was decided that projects qualifying under the Finnish social housing production legislation would also be exempt from the interest barrier rules. This exemption is estimated to cover approximately one-third of all Finnish rental apartments.[10]

Since the exemption in A.T.A.D. is not limited to social housing, the Finnish parliament has, in its response,[11] required that the government and the E.U. Commission continue to assess the possibility of applying a broader exemption to other kinds of Finnish infrastructure projects.

Grandfathering Clauses

As allowed by A.T.A.D., interest expenses payable on certain existing debts are exempt from the restrictions. Interest payments are exempt if paid to parties other than group related parties when the debt is acquired prior to June 17, 2016, provided that no changes to the loan term or loan amount have been made after that date. Also, interest expense that has been activated or included in the acquisition cost of an asset prior to January 1, 2019, falls outside the scope of the new interest barrier rules.

These grandfathering rules strive to ensure that new, stricter rules do not have a harsh retroactive effect, especially on significant long-term investment projects.

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10 Government proposal 150/2018, chapters 4.3.4 and 3.4.3.

11 Response by the Parliament EV 146/2018.

TAKEAWAYS UNDER THE NEW RULES

Although Finland has chosen a fairly broad application of A.T.A.D. exemptions, the new rules are somewhat complex, and they will tighten the Finnish interest deduction regime – especially since the restrictions also cover bank loans and other third-party loans. Here are several points that should be taken into account when contemplating a financing arrangement for a Finnish venture.

“As a result of the new restrictions, it is likely that companies will favor equity financing.”

- The limitations will be broadly applicable to limited liability companies and partnerships, including entities that are taxed under the Finnish Income Tax Act,[12] with exceptions for certain existing loans, Financial Undertakings, social housing projects, and Standalone Entities.
- Companies operating in the real estate investment sector should assess the impact of financing structures.
- Companies in other business sectors planning significant leveraged investments in Finland should take into account the interest barrier rules. Infrastructure projects, other than those related to social housing, fall under the restrictions.
- The definition of interest expense will be broader than in prior years and includes expenses that might not be recorded as interest in the accounts of the company.
- The different thresholds for group and third-party loans mean that taxpayers must monitor both categories and maintain separate baskets for possible non-deductible interest expense being carried forward.

As a whole, the interest deduction limitations probably fulfill their goal: to secure the tax base and to prevent overly aggressive tax planning involving interest deductions. As a result of the new restrictions, it is likely that companies will favor equity financing, especially over shareholder loans and other intra-group loans, in order to avoid non-deductible interest expenses, when possible.

In some situations, it may be possible to plan the group structure to optimize the Tax-E.B.I.T.D. base. In other situations, it could be feasible to utilize multiple debtor entities so that the *de minimis* threshold of €500,000 is not exceeded.

The change in law will cause an administrative burden. Taxpayers and their advisers must familiarize themselves with the new rules to ensure compliance and avoid non-deductible interest expenses. While these rules are based on A.T.A.D., the implementation of the directive will vary among the European countries. Thus, multinational groups and investment structures must account for the differences in various countries.

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[12] The Finnish Income Tax Act (*tuloverolaki*) 1535/1992, as amended.

ADDITIONAL GUIDANCE ON NEW OPPORTUNITY ZONE FUNDS

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On October 19, 2018, just days after publishing our first article on investing in new Opportunity Zones, the I.R.S. issued proposed regulations.

Many believe that the majority of opportunity zone capital will be invested in real estate, and it seems the I.R.S. shares that view, as simultaneously with the proposed regulations, the I.R.S. published Rev. Rul. 2018-29 addressing the manner in which certain aspects of the new provision apply to real property investments.

This article will focus on the new guidance as it relates to the deferral election, as well as qualification as a Qualified Opportunity Zone Fund. The article will address, among other issues, (i) rules relating to the taxpayers that are eligible to make the deferral election, (ii) the type of gains eligible for deferral, (iii) how the 180-day limitation is measured, (iv) the tax attributes of the deferred gain, and (v) the effect of an expiration of qualifying zone status on an election to step up the basis of opportunity fund investments to fair market value after ten years. For a detailed discussion of the basic tax benefits offered by the provision, and an example of its application, see our first article.[1]

BACKGROUND

Broadly stated, new Code §1400Z-2 provides for an election under which taxpayers may roll over capital gains (and only capital gains) into an equity investment in Qualified Opportunity Zone Funds ("Qualified Funds") and achieve three tax benefits:

- Deferral of tax on the capital gains being reinvested
- Up to a 15% reduction in the recognition of the deferred gain upon (the earlier of) a disposition of the new investment or December 31, 2026
- Tax-free appreciation of the new investment (if held for at least ten years)

This provision appeals to both investors wanting to enjoy these tax benefits and real estate developers and other business owners wishing to raise capital from investors.

This provision does not offer developers the "easy money" they might desire. To enjoy the major tax benefits, investors must hold their investments for ten years. Savvy investors are unlikely to tie up funds for this extended period of time or to take the risk of investing in unfamiliar territory without considerable due diligence. An investment must make economic sense before considering the tax benefits.

Nevertheless, the provision does create an opportunity for investors to rollover their investments for the long term into designated areas of the country that need

1 "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit?" *Insights* no. 8 (2018).

economic investment, with considerable tax benefits for investors in successful enterprises. Thus, developers and other business owners in these areas may gain access to more potential investors.

A QUALIFIED OPPORTUNITY ZONE FUND

What Entities Can Qualify as a Qualified Fund?

Any taxpayer classified as a corporation or partnership may qualify. This includes limited liability companies ("L.L.C.'s") that are not taxed as disregarded entities.

Can Foreign Entities Qualify?

Foreign entities cannot be treated as Qualified Funds. Eligible entities include only entities organized in one of the 50 states, the district of Columbia, or one of the U.S. possessions (*e.g.*, Puerto Rico and the U.S. Virgin Islands). An entity organized in a U.S. possession must invest in an Opportunity Zone within its territory in order to be eligible. Other entities are not limited to Opportunity Zones within the state they were formed.

Can Pre-existing Entities Qualify?

An eligible entity must be formed for the purpose of investing in Qualified Opportunity Zone Property ("Eligible Property"). Notwithstanding the aforementioned, the proposed regulations clarify that there is no restriction on pre-existing entities becoming a Qualified Fund, provided that all of the requirements are met – in particular, the entity must acquire the Eligible Property after December 31, 2017.

How Does an Eligible Entity Certify as a Qualified Fund?

Concurrently with publishing the proposed regulations, the I.R.S. published an early draft of the instructions for Form 8996, Qualified Opportunity Fund. This form will be filed together with the electing fund's tax return on an annual basis. The form is expected to be used to certify that the entity is organized to invest in Eligible Property and to report that it meets the investment standard (see below) for a Qualified Fund under the Code or to compute the penalty if it fails to meet the investment standard.

What Is the Effective Date of Qualified Fund Status?

An eligible entity must identify the first taxable year it is to be treated as a Qualified Fund on its first Form 8996 submission. The proposed regulations further provide that a Qualified Fund may designate its first month of qualifying status in that year.

The designation of the first month is of special importance. If an eligible entity fails to designate its first month of qualified fund status, the first month of the first taxable year of the entity will be treated as its effective month.

As discussed below, the Qualified Fund must meet an investment standard confirming that it deployed capital in accordance with the provision and the regulations thereunder. This standard is an average measured at two points during the year. The first is six months after the effective month.

A Qualified Fund may be incentivized to designate a later month than the first month of the first taxable year as its effective date, so as to give itself more time to deploy capital and achieve higher percentages on the first testing period. However, Qualified Funds must be wary of designating an effective month that is later than the first month it accepts capital from investors, as this would prevent investors from enjoying the tax benefits provided by the provision.

What Is the Required Investment Standard for Qualified Funds?

The investment standard requires that at least 90% of a Qualified Fund's holdings be invested in Eligible Property acquired after December 31, 2017.

The 90% test is based on the average of the percentage of total assets that is Eligible Property, as measured on two dates each year:

- After the first six months of the taxable year
- On the last day of the taxable year

For the first year, if the Qualified Fund's first effective month is on July (or later), the 90% test would take into account only the assets held by the fund on the last day of the taxable year.

How Are Assets Valued for Purposes of the 90% Test?

Generally, the proposed regulations provide that if a Qualified Fund prepares certified audited financial statements for its investors and creditors (or is required to prepare such statements by the S.E.C. or another Federal agency other than the I.R.S.), it must use the value of each asset on its financial statement for the reporting period in order to determine whether the 90% test is satisfied.

A Qualified Fund that does not prepare a certified audited financial statement may use the cost of the assets in measuring the 90% test.

What is an Eligible Property?

Eligible Property is one or more of the following:

- *Qualified Stock*: Stock in a domestic corporation that operates a Qualified Opportunity Zone Business on the day the Qualified Fund purchases its stock and during substantially all of the fund's holding period, provided that the stock is purchased at original issue after December 31, 2017, solely for cash
- *Interest in a Qualified Partnership*: A capital interest or profits interest in a domestic partnership that operates a Qualified Opportunity Zone Business during substantially all of the fund's holding period, provided that such interest is purchased from the partnership after December 31, 2017, solely for cash
- *Qualified Business Property*: A tangible property acquired to be used in a Qualified Opportunity Zone Business and which (i) meets the "original use" test or the "substantial improvement" test and (ii) substantially all of the use of the tangible property was in a qualified zone during substantially all of the Qualified Fund's holding period

In simple terms, the investment standard requires that a Qualified Fund directly operate a business in a qualified zone or invest in entities that operate a qualified business.

What Is the Qualified Business Property "Original Use" Test?

Tangible property purchased after December 31, 2017, to be used in a trade or business in an Opportunity Zone will be a Qualified Business Property (and thus an Eligible Property) if its "original use" commences with the Qualified Fund. While the proposed regulations do not elaborate on the meaning of original use at this time, additional guidance will be published in the future.

It is assumed to mean that the purchased property must not have been used in the Opportunity Zone before it was purchased by the Qualified Fund.

For example, if a fund purchases an existing factory building in an Opportunity Zone, the original use of the property in the Opportunity Zone clearly does not commence with the Qualified Fund. Alternatively, if a fund purchases new manufacturing equipment to be used in its Qualified Business, it is assumed that the manufacturing equipment's original use in the Opportunity Zone commences with the Qualified Fund.

What Is the Qualified Business Property "Substantial Improvement" Test?

Tangible property whose original use does not commence with the Qualified Fund can still qualify as a Qualified Business Property (and thus an Eligible Property) if the Qualified Fund "substantially improves" the property following its purchase. A property is considered substantially improved if, during any 30-month period following the purchase of the property, the Qualified Fund invests at least the same amount as the cost to improve the property, so that at the end of this 30-month period the adjusted basis of the property is more than double the original basis.

In the case of real property, the proposed regulations and the Rev. Rul. 2018-29 provide that substantial improvement to a building is measured by additions to the adjusted basis of the building (as allocated to the building in the purchase price allocation). The substantial improvement test does not require the separate improvement of the land on which the building is located.

Because land is not depreciable, taxpayers have always been incentivized to allocate as large a portion of the purchase price as possible to the building. To some degree, this rule could shift the incentive away from allocating most of the purchase price to the building because the higher the building's portion of the purchase price, the greater the capital investment needed.

What Is a Qualified Business?

A Qualified Business is generally any trade or business operated by an entity in which "substantially all" of the property owned or leased is Qualified Business Property (*i.e.*, generally, tangible property purchased after December 31, 2017, whose original use commences with the entity or that is substantially improved by the entity; substantially all of its use in substantially all of the entity's holding period must be in an Opportunity Zone).

The proposed regulations provide for a 70% threshold for purposes of meeting the requirement that "substantially all" of the property owned or leased by an entity be Qualified Business Property. The 70% threshold applies in this context only and not anywhere else the phrase "substantially all" applies.

What Additional Requirements Must Be Met for a Business to Qualify as a Qualified Business?

In addition to having substantially all (*i.e.*, at least 70%) of its owned or leased assets qualify as Qualified Business Property, a Qualified Business must meet the following tests:

- At least 50% of its gross income must be from the active conduct of the business.
- A substantial portion of its intangible property must be used in the active conduct of the trade or business in the qualified Opportunity Zone.
- Less than 5% of the average unadjusted basis of all of its property may be attributable to nonqualified financial assets.

The term "nonqualified financial asset" is defined to exclude "reasonable amounts of working capital" held in cash, cash equivalent, or debt instruments with a term of no more than 18 months. The proposed regulations provide a safe harbor for determining "reasonable working capital" for purposes of meeting the requirements above.

Therefore, if the safe harbor requirements are met (discussed below), reasonable amounts of working capital will not be counted towards the 5% test, and income derived from such amounts will be counted towards the satisfaction of the 50% test. Likewise, the proposed regulations provide that if the business is proceeding in a manner that is substantially consistent with the safe harbor requirements, the business will be treated as meeting the intangible assets use test.

How Is the Working Capital Safe Harbor Satisfied?

The proposed regulations provide that reasonable amounts of working capital are not treated as nonqualified financial assets. The proposed regulations further provide for a safe harbor to treat working capital as reasonable in amount if the following conditions are met:

- There is a written plan that identifies the working capital assets as assets held for the acquisition, construction, or substantial improvement of tangible property in the Opportunity Zone.
- There is written schedule consistent with the ordinary business operations of the business according to which the property will be used within 31 months.
- The business substantially complies with the written plan and the written schedule in the manner that it employs the assets.

The proposed regulations also provide that if tangible property is expected to be substantially improved as a result of expending the working capital, an entity that meets the working capital safe harbor requirements will not be treated as failing to meet the Qualified Business Property requirements solely because the scheduled consumption of the working capital is not yet complete.

In an example provided in the proposed regulations, a Qualified Fund invested 100% of its capital in a partnership interest, which immediately placed the funds in working capital assets. The example provides that the partnership had a written plan to acquire land in a qualified Opportunity Zone on which it planned to construct a commercial building. A certain portion of the funds was dedicated to the land purchase, a different amount was dedicated to the construction of the building, and the remainder of the funds was dedicated to ancillary but necessary expenditures for the project. The written plan provided for the purchase of the land within a month of the receipt of the cash from the Qualified Fund and for the remaining amounts to be spent within the next 30 months as per the dedicated plan. All expenditures were made on schedule and, therefore, the safe harbor requirements were met. As a result, the Qualified Fund's investment in the partnership satisfies the 90% investment standard. Lastly, the proposed regulations add that the above conclusion would also apply if the partnership's plans had been to buy and substantially improve a pre-existing commercial building, and the fact that the partnership's basis in the building has not yet doubled does not cause the building to fail to satisfy the requirements for a Qualified Business Property.

Are All Types of Businesses Permitted as Qualified Businesses?

Certain businesses are prohibited *per se* from being a Qualified Business. Those include, *inter alia*, casinos, liquor stores, golf courses, and country clubs.

In Sum, What Are the Requirements for an Entity to Be a Qualified Fund?

To qualify as a Qualified Fund, a U.S. entity taxed as a corporation or a partnership must invest 90% of its assets in Eligible Property, which can take two forms:

- Equity interest in an entity that operates a Qualified Business
- Qualified Business Property

The Qualified Fund must deploy its capital within a short period of time in order to meet the 90% test for the taxable year. The 90% test is based on the average of the fund's total assets that are invested in Eligible Property, as measured at two times during a taxable year: (i) six months after the effective date of the fund's election to be treated as a Qualified Fund and (ii) at the end of the taxable year.

A reasonable working capital safe harbor allows for some flexibility, so that cash held for the acquisition, construction, or substantial improvement of tangible property will not cause the fund to fail the investment standard if it will be used, under a written plan, within 31 months.

The investment standard allows entities to qualify if they invest directly in Qualified Business Properties or if they invest in Qualified Businesses operated by other entities. To be a Qualified Business, 70% of the entity's assets must be Qualified Business Properties. As a result, the proposed regulations, as currently drafted, provide an incentive for funds to invest in other entities operating a Qualified Business rather than to invest directly in Qualified Business Properties. Investing in a Qualified Business allows greater diversification of assets beyond Opportunity Zones. This incentive is the result of the 70% threshold, which means that if the fund invests in equity interests in other entities, only 63% of the fund's assets must be invested in Qualified Business Properties (assume the fund invests 90% of its capital in a Qualified Business that must invest 70% of its assets in Qualified Business Properties). In contrast, if the fund were to operate a Qualified Business directly, 90% of the fund's capital would have to be invested in Qualified Business Properties.

OPPORTUNITY ZONE TAX BENEFITS

How Does the Tax Deferral Benefit Work?

To be eligible to defer the tax on gain realized, taxpayers must

- sell an appreciated property to an unrelated person before December 31, 2026,[2]
- make an election to defer the gain (or the invested amount, if lower) in the tax return for the year of the sale,
- not have another election to defer the tax in effect, and
- invest the deferred gain in an equity investment in one or more Qualified Funds within 180 days from the day of the disposition.

"Non-U.S. taxpayers, including trusts, may benefit from the provision as long as the invested funds are U.S.-source capital gains that would have been recognized for U.S. Federal tax purposes."

While the tax is deferred, the disposition transaction must be reported in the year it was made on Form 8949, *Sales and Other Dispositions of Capital Assets*, which will also be used to make the election to defer the tax, pending further instructions from the I.R.S. The preamble to the proposed regulations provides that form instructions to this effect are expected to be released shortly, but none have been published so far.

Which Taxpayers Are Eligible to Benefit from the New Provision?

The proposed regulations provide that any person who may recognize gains for Federal income tax accounting is eligible to benefit. This includes individuals; C-corporations, including R.I.C.'s and R.E.I.T.'s; L.L.C.'s; partnerships; S-corporations; trusts; and estates.

Can Non-U.S. Taxpayers Benefit from the Provision?

The Code and the proposed regulations do not limit eligible taxpayers to U.S. taxpayers. Accordingly, non-U.S. taxpayers, including trusts,[3] may benefit from the provision as long as the invested funds are U.S.-source capital gains that would have been recognized for U.S. Federal tax purposes if it were not for the election to defer the tax under this provision.

As mentioned in our earlier article,[4] while non-U.S. persons do not recognize capital gains on the disposition of stocks and securities, non-U.S. persons may recognize capital gains on the disposition of U.S. real property interests ("U.S.R.P.I.") and, following the tax reform, on the disposition of an interest in a partnership. The Code and the proposed regulations do not address the applicability of the provision to non-U.S. taxpayers and the withholding that would apply to any gain they realized under F.I.R.P.T.A. and the new provision applicable to a sale of a partnership

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2 In determining whether two persons are related, certain modified constructive ownership rules apply. In the case of a partnership, the sale of the property cannot be made to a person related to the partnership or to any of the partners.

3 Certain U.S. trusts controlled by foreign persons have seen a rise in popularity in recent years, following the implementation of the C.R.S. These trusts are generally taxed as foreign (non-U.S.) trusts for U.S. tax purposes.

4 "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit?"

interest. Since the consideration may be subject to 15% F.I.R.P.T.A. withholding, or to the new 10% withholding on the sale of a partnership interest, foreign taxpayers may find it complicated to utilize the new provision.

Nevertheless, although the proposed regulations remain silent, it is anticipated that non-U.S. taxpayers will be able to apply to the I.R.S. and request a withholding certificate to eliminate the withholding. There is no doubt that this would impose some complications; however, unless future guidance impose limitations, the benefits may be worth it.

The process to obtain an I.R.S. withholding certificate normally takes 90 days and first requires the issuance of a U.S. Tax Identification Number, which may take time. However, well-advised taxpayers who plan in time may be able to invest the proceeds within the required 180 days and reap the benefits of this new provision.

Note, that in addition to the general eligibility of non-U.S. taxpayers, it is common for non-U.S. persons to use U.S. structures, specifically, U.S. domestic trusts, which are used to benefit family members treated as U.S. persons, and these structures can surely benefit from the provision and take the opportunity to cash out on appreciated portfolios.

What Types of Gains Are Eligible for the Benefit?

While the Code did not limit the type of gain to which the provision applies, the proposed regulations follow the legislative history and limit the application to gain that is treated as capital gain for Federal income tax purposes. This includes gain from a deemed sale or exchange, or any other gain that is required to be included in the taxpayer's tax return.

Can Gain from Code §1256 Contracts Be Deferred?

Section 1256 contracts are marked to market on the last day of the taxable year; the taxpayer need not dispose of the contract. As a result, capital gain may be recognized for Federal tax purposes, and the amount recognized may be eligible for deferral.

Since some contracts may result in a loss, the proposed regulations provide that only the net income from all §1256 contract positions is treated as gain eligible for deferral.

Additionally, the proposed regulations disallow the tax deferral of any §1256 contract gain if, at any time during the taxable year, one of the taxpayer's §1256 contracts was part of an offsetting-position transaction in which any of the other positions was not also a §1256 contract. An offsetting-position is defined in the proposed regulations as a transaction that eliminates a taxpayer's risk of loss. With respect to gain from offsetting-position transactions, including straddles, the proposed regulations disallow any tax deferral.

Can Foreign-Source Gains Be Deferred?

There is no limitation relating to foreign-source gain. As long as the foreign-source gain would be subject to Federal tax, the deferral election should be available.

Unlike a §1031 exchange, which only allows deferral on exchanges of real estate and only if the rolled over property is like-kind and which does not treat foreign real property as like-kind U.S. real property, this provision does not require U.S.-source investment. Therefore, foreign-source capital gain, which would have been recognized for Federal tax purposes if it were not for the deferral election, can be invested in a Qualified Fund and be eligible for the tax benefits described.

Note that if the foreign-source gain is subject to foreign tax at a rate that is equal to or higher than the U.S. rate (as low as 20% for long-term capital gains or as high as 37% for short-term capital gains), no U.S. tax will be due at the time of the disposition as a result of the foreign tax credit. Thus, the deferral may not be desirable.

Is There a Limitation on the Amount of Gain that Can Be Deferred?

There is no limitation on the amount of gain that can be deferred by reinvestment, provided that the amount deferred is invested in accordance with the provision.

Similarly, not all of the gain realized must be deferred. A taxpayer may elect to defer only a part of the eligible gain.

Can a Taxpayer Invest More Than the Gain Realized?

Cash investments from sources other than deferred capital gain do not qualify for the benefits of the provision. Therefore, investments of more than the realized gain will be treated as an investment of "mixed funds." In such circumstances, the Qualified Fund must segregate the total amount of investment to be treated as two separate investments. All potential step-up benefits would only apply to the investment of the deferred gain to which an election applies.

The proposed regulations provide that transactions resulting in a deemed contribution to a partnership (*e.g.*, as a result of an increase in liabilities allocated to a partner) would not be treated as an additional investment in a Qualified Fund and will be ignored (*i.e.*, will not be treated as an eligible investment nor as a mixed fund investment).

Can a Taxpayer Split the Deferral Election with Respect to Gain from a Single Sale?

Under the provision as drafted in the tax reform, it seemed that not utilizing all of the gain at the time of the deferral election would prohibit the taxpayer from making a second election to defer tax on the other portion of the gain. The proposed regulations clarify that this is not the case.

Under the proposed regulations, a taxpayer may elect to defer tax on part of the gain from a sale and later, but still within the 180 days, make a second election to invest, and defer tax on, the unused portion of the gain from the same sale. The taxpayer will not be restricted by the limitation requiring that it not have another election to defer the tax in effect. Likewise, the second investment will not be treated as an investment of unqualified cash nor as a mixed fund investment.

How Can Capital Gain Realized by a Pass-Thru Entity Be Deferred Under the Provision?

Partnerships and other pass-thru entities are eligible taxpayers who can make the election to defer tax on all or part of the gain. If the partnership makes the election to defer the gain, no part of the gain will be included in the partner's distributive share.

To the extent that the partnership does not make the election, each partner or member may elect to defer the gain allocated to him or her, provided that it satisfies the requirements.

What Types of Investments in Qualified Funds Are Eligible?

The proposed regulations provide that the deferral is only available if the rolled-over investment is made in an equity interest in the Qualified Fund. Equity interests include preferred stock or partnership interests with special allocations. An investment in a debt instrument of a Qualified Fund is ineligible as a rollover investment. Notwithstanding the aforementioned, an equity interest in a Qualified Fund may serve as a collateral for a loan.

What Is the Timeframe to Rollover the Gain into an Investment in a Qualified Fund?

The deferred gain must be invested in a Qualified Fund within 180 days of the day of disposition of the property. The proposed regulations provide that this means the day on which the gain would be recognized for Federal income tax purposes.

How Is the 180-Day Period Measured when Gain Is Realized by a Partnership?

With respect to gain realized by a partnership and allocable to a partner, the 180-day period begins on the day on which the partner would be required to recognize the gain (*i.e.*, on the last day of the partnership's taxable year). Nevertheless, if a partner has knowledge as to the partnership's disposition of an asset, and that the partnership does not intend to make a deferral election, the proposed regulations allow the partner to choose to begin its 180-day period on the day that the partnership recognizes the gain rather than the day the partner would.

How Is the 180-Day Period Measured for §1256 Contracts?

Contracts that were not disposed of result in gain recognition at the end of the taxable year. Thus, the proposed regulations provide that the 180-day period begins on the last day of the taxable year.

How Long Does the Tax Deferral Last?

The gain is deferred until the earlier of (i) the time that the rolled-over investment is disposed of or (ii) December 31, 2026.

Can Gain Recognition Be Deferred with a Second Election and Rollover into a Different Qualified Fund?

Under the proposed regulations, gain from a sale of an interest in a Qualified Fund that meets the requirements (*i.e.*, is sold to an unrelated person before December 31, 2026) is eligible for a deferral, provided that the gain is invested in a Qualified Fund within 180 days. The portion of the consideration eligible for a deferral includes both the appreciation in the value of the interest in the Qualified Fund, as well as the portion of the previously deferred gain, which will be eligible for a second deferral.

For the original gain to be eligible for the second deferral, the taxpayer must dispose of the entire interest in the Qualified Fund. Otherwise, the deferral would be disallowed on the basis that the taxpayer may not have another election to defer the tax in effect.

In any event, it seems the deferral cannot be extended beyond December 31, 2026.

This opportunity for a second election gives taxpayers flexibility, enabling them to exchange an investment in a Qualified Fund that they view as underperforming for an investment in a different Qualified Fund. However, the proposed regulations are silent on whether this will reset the holding periods for the partial step-up when gain is recognized (discussed below) and for the fair market value step-up after ten years. A reset in the holding period may disincentivize exchanges.

"In order to benefit from the 15% step-up, taxpayers should invest in Qualified Funds before December 31, 2019."

How Much of the Gain Is Recognized Eventually?

When the investment is disposed of, the taxpayer includes in his or her gross income the full amount of the deferred gain over the taxpayer's basis in the rolled-over investment. The taxpayer's basis in the investment is zero, unless the taxpayer held the investment for at least five years. If the holding period was at least five years, a partial step-up in basis is available, resulting in a lesser amount recognized (see discussion later).

If the investment in the Qualified Fund diminished, the inclusion will be reduced, and instead of recognizing the full amount of deferred gain, only the fair market value of the investment in the Qualified Fund over the basis in the investment will be recognized.

What Are the Tax Attributes of the Recognized Gain?

Capital gains deferred under the provision preserve their tax attributes. This includes the holding period for applying the short- or long-term capital gains tax rates.

The proposed regulations provide ordering rules for cases where a taxpayer disposes of only a part of an interest in a Qualified Fund and the gain invested did not all have the same attributes. Under these rules, the "first-in, first-out" ("F.I.F.O.") method is applied, and if this is insufficient to determine the tax attributes of the disposed portion, a *pro rata* method is applied.

How Does the Partial Step-Up Work?

After five years, the taxpayer is eligible for a step-up in the basis of the investment in the Qualified Fund. This step-up is 10% of the deferred gain. After seven years, the taxpayer is eligible for an additional 5% step-up, resulting in a total step-up of up to 15% of the deferred gain.

Since gain cannot be deferred beyond 2026, in order to benefit from the 15% step-up, taxpayers should invest in Qualified Funds before December 31, 2019. Taxpayers investing in Qualified Funds after January 1, 2020, but before January 31, 2021, can benefit from a 10% reduction in gain recognition. Taxpayers investing in Qualified Funds after January 1, 2022, cannot not enjoy a reduction in gain recognition but can still benefit from tax deferral on the gain (until December 31, 2026) and from tax-free appreciation if they hold the interest in the Qualified Fund for at least ten years.

What Are the Benefits for an Investment Held for Ten Years?

If an investment in a Qualified Fund is held for at least ten years, the taxpayer can elect to step up the basis in the interest to the fair market value of the interest at the time of the disposition, thereby eliminating the tax on post-acquisition gain.

While no more than 15% of the deferred gain can be exempt from tax, the gain derived from the investment in the Qualified Fund may be completely tax-free if the taxpayer elects to step up the basis to the fair market value on the day of the disposition.

The fair market value step-up is only available with respect to appreciation of the portion of the investment made by deferring capital gains under the provision. As mentioned above, investment of mixed funds is treated as two separate investments, so that the portion of the appreciation attributable to ineligible funds would not benefit from this fair market value step-up election.

What Happens if the Ten-Year Period Falls After an Opportunity Zone Has Lost its Designation as Such?

A qualified Opportunity Zone's designation expires on December 31, 2028. Therefore, investments made after December 31, 2018, and for which taxpayers wish to benefit from the ten-year fair market value step-up, will be disposed of after the opportunity zone designation has expired. The proposed regulations clarify that as long as the investment is disposed of before December 31, 2047, the expiration of opportunity zone status will not create a problem for taxpayers electing to step up the basis of their investment to its fair market value.

"The gain derived from the investment in the Qualified Fund may be completely tax-free if the taxpayer elects to step up the basis to the fair market value on the day of the disposition."

CONCLUSION

The advent of the Opportunity Zone has created a huge commotion. It is viewed by many as one of the biggest tax benefits offered in the history of the U.S.

Yet many have criticized the provision, claiming that, despite the well-intended mission, capital investments in distressed areas could end up benefiting cities that are already experiencing growth. This is already the case in Long Island City, an Opportunity Zone in one of the country's most prosperous cities, New York, where Amazon has chosen to build its HQ2 and which even now offers luxury rentals to professionals working in Manhattan.

Ultimately, though the tax benefits are great, it remains to be seen whether the stir around Opportunity Zones is justified. The holding period requirement is significant; many of the Opportunity Zones are unfamiliar territories; and substantial improvement requirements could double the cost of the property, consuming funds that might otherwise not be spent on improvement and which may ultimately reduce the anticipated yield of a project. With these considerations, are Opportunity Zones worth the hype?

Investors should carefully consider how and where to utilize this benefit.

CODE §962 ELECTION: ONE OR TWO LEVELS OF TAXATION?

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Code §965
Code §962 Election
G.I.L.T.I.
Smith v. Commr.

Since 1962, a 10%[1] individual U.S. Shareholder in a controlled foreign corporation ("Individual U.S. Shareholder" and "C.F.C.," respectively) can elect to be treated as a corporation for Code §951(a) purposes.[2] As a result of this election, the individual is taxed at corporate rates on its Subpart F Income. Another main benefit of the election is that it enables the individual to claim indirect foreign tax credits for foreign income taxes paid by the C.F.C. on its Subpart F Income.[3] An actual distribution of Subpart F Income to the individual is then taxed to the extent the distribution exceeds the taxes paid on the Subpart F inclusion under the Code §962 election.[4]

Under Public Law 115-97, two new provisions allow for the Code §962 election in additional scenarios: the global intangible low taxed income ("G.I.L.T.I.") regime and the one-time deemed repatriation tax regime of Code §965. This begs the question, is an actual distribution under these regimes subject to traditional treatment under Code §962, or does the new law provide for a different result?

ACTUAL DISTRIBUTIONS PURSUANT TO CLASSIC CODE §962 ELECTIONS

As indicated earlier, an Individual U.S. Shareholder is taxed at corporate rates on its Subpart F Income if a Code §962 election is made. Further, indirect foreign tax credits may be available under Code §960.[5] If the C.F.C. makes an actual distribution to the Individual U.S. Shareholder, the Individual U.S. Shareholder must include in gross income the excess of the earnings and profits ("E&P") over the amount of income tax paid by the Individual U.S. Shareholder on such E&P pursuant to a Code §962 election.[6] However, an actual distribution from the C.F.C. to the Individual U.S. Shareholder may be taxed at an adverse rate.

In *Smith v. Commr.*,[7] the Tax Court was asked to examine serval issues, including whether an actual distribution of taxable E&P from a C.F.C. located in Hong Kong (prior to which the Individual U.S. Shareholder had made a Code §962 election) could constitute a qualified dividend for purposes of Code §1(h)(11)(B)(i) and, hence, benefit from the lower Qualified Dividend income tax rate.

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1 By vote or value.

2 Code §962(a)(1).

3 Code §962(a)(2).

4 Code §962(d).

5 *Supra* n. 3.

6 *Supra* n. 4.

7 *Smith v. Commr.*, 151 T.C. 5, U.S. Tax Court, 09/18/2018.

Code §1(h)(11)(C)(i) defines the term "Qualified Dividend" as a dividend received during the taxable year from (i) Domestic Corporations and (ii) Qualified Foreign Corporations. For this purpose, a Qualified Foreign Corporation is any foreign corporation if (i) the foreign corporation is incorporated in a possession of the U.S. or (ii) the corporation is eligible for benefits under a comprehensive income tax treaty with the U.S. that the Secretary determines is satisfactory for this purpose and that includes an exchange of information program.

In determining that the taxable amount of distributed E&P did not qualify as a Qualified Dividend, the Tax Court looked at the Hong Kong C.F.C. Since no income tax treaty existed between Hong Kong and the U.S., no qualified dividend treatment could apply to a taxable dividend distribution pursuant to Code §1(h)(11)(C)(i).

The Tax Court also made it clear that a Code §962 election by a taxpayer did not create a "notional" Domestic Corporation for dividend characterization purposes.

Thus, in determining qualified or ordinary dividend treatment, the taxpayer must look at whether dividends received from the C.F.C. would constitute Qualified Dividends.

The Tax Court's decision appears to be in line with the Senate Finance Committee Report related to the adoption of Subpart F in 1962:

> In addition to the minimum distribution schedule and export trade corporation provision which may exclude from the tax base of U.S. Shareholders undistributed income of controlled foreign corporations, the bill provides two other important relief measures. First, it provides that a U.S. shareholder who is an individual may elect to be taxed upon any undistributed income of a controlled foreign corporation attributed to him as if he were a corporation rather than an individual. If he makes this election this means that he will be subject to a 30-percent tax on the first $25,000 of undistributed income allocated to him and a 52-percent tax on all income allocated above this level. Against this 52-percent or 30-percent tax rate, credits will be allowed for income and other creditable taxes paid by the controlled foreign corporation to foreign countries in the same manner as if the individual were a domestic corporation.
>
> The purpose of this provision is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad.
>
> If an individual has elected with respect to the earnings of a controlled foreign corporation to be treated as if he were a domestic corporation, and then subsequently an actual distribution is made, the bill provides that he then is to be taxed only on the excess of the amount received over the amount of taxes he previously paid with respect to the undistributed income. Therefore, if the individual were to be taxed on $100 of undistributed income at a 52-percent tax rate,

"In determining qualified or ordinary dividend treatment, the taxpayer must look at whether dividends received from the C.F.C. would constitute Qualified Dividends."

> and then subsequently the $100 was paid to him as a dividend, he would be taxed at individual income tax rates only on $48, namely, the excess of the amount distributed to him over the taxes he previously paid, assuming the foreign country involved had no income taxes.[8]

ACTUAL DISTRIBUTIONS AFTER CODE §962 ELECTIONS UNDER CODE §965 AND G.I.L.T.I.

Under Code §965

Code §965 provides that, for the last taxable year of a deferred foreign income corporation ("D.F.I.C.") beginning prior to January 1, 2018, the U.S. Shareholder of the D.F.I.C. must include in income its *pro rata* share of the accumulated post-1986 deferred foreign earnings of the D.F.I.C. A part of this inclusion amount is deductible, so as to arrive, for corporate taxpayers, at an effective 15.5% or 8% income tax rate on such amount. The effective corporate tax rate is 15.5% for the part of the inclusion amount that equals the cash held by the corporation on a specific date. The 8% tax rate applies to the excess, if any, of the inclusion amount over the cash held by the corporation on that specific date. However, for individual shareholders, the effective tax rates, after deduction, are higher than 15.5% or 8% since the computation of the effective tax rate is based on corporate income taxes and not individual income taxes.

The Joint Committee on Taxation's General Explanation of Public Law 115-97 states, in relevant part:

> The rate equivalent percentages are intended to ensure that deferred foreign income of U.S. shareholders is generally subject to comparable rates of tax, without regard to the type of U.S. person who is the shareholder or the different rates of income tax to which a taxpayer may be subject. Individuals who are U.S. shareholders, as well as the individual investors in U.S. shareholders that are pass-through entities, may achieve rate parity with corporate shareholders by electing application of corporate rates for the year under inclusion, under section 962. That section allows such individual U.S. shareholders to make the election for a specific taxable year, subject to regulations provided by the Secretary. ***Consistent with the goal of rate parity where possible, and to avoid duplicative tax on the amounts included in income under this provision, the entire amount of such inclusion, without reduction for the partial participation exemption deduction, is considered previously taxed income of the DFIC for purposes of subpart F*** [emphasis added].[9]

At first glance, the last sentence could be read as indicating that no second level of taxation would occur upon distribution, since the entire inclusion amount, not decreased by the allowable reduction, constitutes previously taxed income of the

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8 S. Rept. No. 87-1881, at 92 (1962), 1962-3 C.B. 703, 798.

9 Joint Committee on Taxation, *General Explanation of Public Law No. 115–97* (JCS–1–18), December 2018, p. 361.

foreign corporation for Subpart F purposes. This would suggest that regulations to be promulgated under Code §965 would effectively override Code §962(d), which states that:

> The earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) and with respect to which an election under this section applied shall, when such earnings and profits are distributed, ***notwithstanding the provisions of section 959(a)(1)***, be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid under this chapter on the amounts to which such election applied [emphasis added].

Unless Code §965 regulations or other guidance say otherwise – which, arguably, would be in line with the highlighted material above – a subsequent actual distribution of amounts previously taxed under Code §962 could be taxed as a dividend to the extent the distribution exceeds the U.S. income tax previously paid. Qualified dividend treatment would be available only to the extent the foreign distributing corporation is resident in a qualifying treaty partner jurisdiction, as provided by the *Smith* case.

Under Code §951A

A U.S. Shareholder must include its G.I.L.T.I. amount in gross income. Corporate U.S. Shareholders are entitled to a 50% deduction on this G.I.L.T.I. amount included in gross income when determining at the taxpayer's taxable income. The 21% corporate income tax rate is then applied to such taxable amount.[10]

Code §962 provides that if an Individual U.S. Shareholder makes a Code §962 election, he or she should be subject to tax on items included in gross income pursuant to Code §951(a) as if such individual were a corporation. Further, as indicated earlier, the legislative history to Code §962 indicates that an individual making a Code §962 election should be in the same position as a corporation with regard to amounts included in gross income under Code §951(a). Finally, the Joint Explanatory Statement of the Committee of Conference to Public Law 115-97 states that:

> Although GILTI inclusions do not constitute subpart F income, GILTI inclusions are generally treated similarly to subpart F inclusions. Thus, they are generally treated in the same manner as amounts included under section 951(a)(1)(A) for purposes of applying section . . . 962.[11]

Therefore, it may be inferred that an individual who has an income inclusion under G.I.L.T.I. and makes a Code §962 election with regard to such inclusion is entitled to the 50% deduction available to corporations. Barring further guidance eliminating a second level of tax (which one may assume was intended by the new legislation), a subsequent distribution should be treated as a dividend in the hands of the Individual U.S. Shareholder, with qualified dividend rates available only if the C.F.C. is in a treaty partner jurisdiction.

10 Code §11.

11 Committee of Conference, *Joint Explanatory Statement to Public Law 115-97*, December 2017, p. 517.

CONCLUSION

Could distributions to Individual U.S. Shareholders in the context of Code §§965 and 951A be taxed a second time upon an actual distribution? In the context of Code §965, the Joint Committee's explanation suggested that no such second level of tax should be imposed. A similar policy argument can be made for the application of Code §951A. Further clarification, in the form of Treasury regulations or otherwise, would be highly desirable to give an assurance to taxpayers as to the correct tax treatment.

Final regulations under Code §965 were promulgated in January 2019. In response to a specific comment asking for clarification on this point, the Treasury stated a second level of tax would be imposed on a subsequent distribution and that no relief was appropriate. Consequently, taxpayers should anticipate that a second level of tax will be imposed upon a subsequent distribution.

ATTORNEY-CLIENT PRIVILEGE EXTENDS TO ACCOUNTANTS RETAINED BY LEGAL COUNSEL

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Tags
Accounting
Attorney-Client Privilege
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INTRODUCTION

The attorney-client privilege is a common law concept that dates back several centuries. The privilege protects information disclosed by the client to the attorney for the purpose of obtaining legal advice. Over time this concept has been extended to include communications to third parties retained by legal counsel to assist the attorney in providing legal advice.

SCOPE OF THE ATTORNEY-CLIENT PRIVILEGE

The seminal case is *U.S. v. Kovel*,[1] where the court extended the attorney-client privilege to cover client communications to an accountant engaged by legal counsel to assist on the case. Information was provided on a confidential basis by the client directly to the accountant. The U.S. government unsuccessfully sought access to the communication, contending that legal privilege did not extend to communications with an accountant. The court held that attorney-client privilege applied because the disclosures were made in confidence for the purpose of obtaining legal advice from legal counsel.

The attorney-client privilege belongs to the client, not the attorney. Consequently, when the privilege is attacked by an opposing party, such as the I.R.S. criminal investigation division, the privilege must be asserted by the client. Moreover, it is not always easy to identify the client, especially in a corporate setting.

Before the decision in *Upjohn v. U.S.*,[2] courts held that the privilege applied only to communications between counsel and those employees within the corporation's "control group."[3] In *Upjohn v. U.S.*, the Supreme Court determined that the privilege protects information given to counsel by employees to enable counsel to give the corporate client sound and informed advice. Consequently, certain communications by middle-level and lower-level employees are also protected by the privilege, because these employees may have information necessary for legal counsel to adequately advise the client regarding actual or potential legal difficulties.

For a client to assert the attorney-client privilege, the parties to the communication in question must bear the relationship of attorney and client, and the attorney must have been engaged or consulted by the client for the purpose of rendering legal

1 *U.S. v. Kovel*, 296 F.2d 918, 921–22 (2nd Cir. 1961).

2 *Upjohn Co. v. U.S.*, 449 US 383 (1981).

3 *Philadelphia v. Westinghouse Elec. Corp.*, 210 F. Supp. 483 (ED Pa.1962).

services or advice.[4] Therefore, if an attorney is hired for any other purposes, the attorney-client privilege will not apply. [5]

The privilege can be waived. Generally, if the privileged information is communicated to someone outside the scope of attorney-client privilege then the privilege is waived. Both the client and the attorney should be careful when disclosing the privileged information, so as to not waive the privilege.

"The attorney-client privilege belongs to the client, not the attorney."

TAX PREPARER PRIVILEGE

Initially, in tax matters, advice received by a taxpayer from a non-attorney did not benefit from privilege. As a result, communications from a taxpayer's accountants, whether in the form of a planning memorandum, discussions of various options, or audit work papers relating to a tax provision, were subject to disclosure to the I.R.S. This was changed by the I.R.S. Restructuring and Reform Act of 1998 (the "Act"), which extended a form of client privilege to any communications between a taxpayer and a Federally authorized nonlawyer representative. The Act provides that with respect to any tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney would also apply to a communication between a taxpayer and any Federally authorized tax practitioner, to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.[6] In addition to licensed attorneys, Federally authorized tax practitioners include C.P.A.'s, enrolled agents, and enrolled actuaries authorized to practice before the I.R.S. This extension of privilege may only be asserted in noncriminal tax proceedings before the I.R.S. and in Federal courts, such as the Tax Court, the Claims Court, and Federal district courts.[7]

I.R.S. ATTACKS ON CLAIMS OF PRIVILEGE

The availability of the common-law privilege to a third party has been heavily litigated. The basic concept of privilege is to safeguard the communications between an attorney and a client to encourage disclosures that will facilitate the client's compliance with law and better enable the attorney to present legitimate arguments when litigation arises.[8] In *Kovel*,[9] the court analogized an accountant retained by legal counsel to assist in providing competent legal advice to an interpreter retained by legal counsel for purposes of assisting in communication with a client not fluent in English:

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4 *Diversified Indus., Inc. v. Meredith*, 572 F2d 602 (where a law firm conducting an investigation was held to be acting in legal capacity).

5 *Coulton*, 201 F. Supp. 13, 16 (SDNY 1961), aff'd, 306 F2d 633 (2d Cir. 1962), cert. denied, 371 US 951 (1963) (where the attorney was hired to act solely as an accountant); *JP Foley Co. v. Vanderbilt*, 65 FRD 523, 526 (SDNY 1974) (where the attorney was hired to act only as a negotiator or business agent).

6 Code §7525(a)(1).

7 Code §7525(a)(2). The provision does not, however, limit the present attorney-client privilege of confidentiality.

8 *U.S. v. Mass. Inst. of Tech.*, 129 F.3d 681, 684 (1st Cir. 1997); Upjohn v. U.S., 449 U.S. 383, 389, 101 S. Ct. 677, 66 L. Ed. 2d 584 (1981).

9 *Supra* note 1.

> Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege, any more than would that of the linguist in the second or third variations of the foreign language theme discussed above; the presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit. By the same token, if the lawyer has directed the client, either in the specific case or generally, to tell his story in the first instance to an accountant engaged by the lawyer, who is then to interpret it so that the lawyer may better give legal advice, communications by the client reasonably related to that purpose ought fall within the privilege; there can be no more virtue in requiring the lawyer to sit by while the client pursues these possibly tedious preliminary conversations with the accountant than in insisting on the lawyer's physical presence while the client dictates a statement to the lawyer's secretary or in interviewed by a clerk not yet admitted to practice. What is vital to the privilege is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer.

However, if the service sought by the client is not legal advice from competent legal counsel but accounting services or tax advice from the accountant's rather than the lawyer's, no attorney-client privilege exits.

U.S. V. ADAMS: ATTORNEY-CLIENT PRIVILEGE PREVAILS OVER CHALLENGE

It is one thing for a taxpayer to raise the attorney-client privilege under *Kovel* for communications with a non-lawyer retained by counsel, but it is another thing for the I.R.S. to respect the claim. Over the years, cases asserting the attorney-client privilege to a third-party agent of legal counsel have involved a public relations firm,[10] an independent contractor,[11] and of course a C.P.A. A recent example is *U.S. v. Adams*,[12] in which the U.S. government raised multiple challenges to the privilege.

In *Adams*, an accounting firm was retained by tax counsel under a Kovel arrangement. The taxpayer communicated often with the accountant. The I.R.S. issued a subpoena to obtain access to the written communications and issued a summons to the accountant seeking testimony. The taxpayer asserted the attorney-client privilege in an attempt to quash the summons and the subpoena, in legal proceedings brought in district court.

The government raised three challenges to the assertion of the attorney-client privilege:

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10 *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53 (S.D.N.Y. 2000).

11 *Twentieth Century Fox Film Corp. v. Marvel Enterprises, Inc.*, 2002 WL 31556383 (S.D.N.Y Nov. 2002).

12 *U.S. v. Adams*, (DC MN 10/27/2018) 122 AFTR 2d ¶2018-5380.

- The communications do not qualify for the protections of the privilege.

- If the communications qualify for the privilege, all protection was waived by the taxpayer's subsequent filing of amended tax returns prepared by the accountant. Because a tax return is intended to provide information to the I.R.S. and the I.R.S. is responsible for examining the accuracy of tax returns, it is entitled to obtain information relevant to the preparation of the return. When the accountant prepared the return that was submitted to the I.R.S., any claim to privilege disappeared.

- The crime-fraud exception invalidated any claim of privilege. Generally, under the crime-fraud exception, the attorney-client privilege does not apply to a communication made for the purpose of getting advice for the commission of a fraud or a crime.[13]

In analyzing the case, the court relied on legal counsel's declaration that the taxpayer's communications to the accountants assisted him in his provision of legal advice to his client regarding the tax-related matters. The court found that legal counsel's declaration was sufficient to invoke the attorney-client privilege.

To determine if Mr. Adams waived the privilege by filing amended tax returns that were prepared by the same accountant that was retained by legal counsel, the court cited *Cote*,[14] where the court concluded that the privilege could apply to communications between a client and an accountant who is retained to assist an attorney in providing legal advice on tax matters. The court reasoned as follows:

> Notwithstanding our recognition that the attorney-client privilege attached to the information contained in the accountant's workpapers under the circumstances existing here, we find that by filing the amended returns the taxpayers communicated, at least in part, the substance of that information to the government, and they must now disclose the detail underlying the reported data.

However, the court cautioned on broad application of the waiver, as it may destroy the purpose of privilege that invites confidentiality between the attorney and the client. The *Cote* court distinguished between "workpapers [that] contain detail of unpublished expressions which are not part of the data revealed on the tax returns" and other workpapers to which the rule of waiver would apply.

The court in *Adams* distinguished between documents that related to the information that was later transcribed onto tax returns filed with the I.R.S. and communications between the taxpayer and the accountant that comprised unpublished expressions never revealed on the amended tax returns. The attorney-client privilege was waived in connection with the former documents. However, it remained available as a defense against the subpoena and the summons.

Regarding the crime-fraud exception to the attorney-client privilege, the government suggested that the taxpayer communicated with the accountants and legal counsel to further the submission of fraudulent tax returns, and therefore, the crime-fraud

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13 *In re Green Grand Jury Proceedings*, 492 F.3d 976, 979 (8th Cir. 2007) (quoting *U.S. v. Zolin*, 491 U.S. 554, 563 (1989)).

14 *U.S. v. Cote*, 456 F.2d 142 (8TH Cir. 1972).

exception applied. For the crime-fraud exception to apply, the government need only demonstrate that the legal advice was obtained to further an illegal or fraudulent scheme. The burden of proof is relatively low. All that must be demonstrated is a factual basis adequate to support a good faith belief by a reasonable person that an *in camera* review of the materials may reveal evidence to establish the claim that the crime-fraud exception applies.[15] To determine whether a *prima facie* showing has been made, the court may review any relevant evidence that has not been adjudicated to be privileged.

"For the crime-fraud exception to apply, the government need only demonstrate that the legal advice was obtained to further an illegal or fraudulent scheme."

The court concluded that a reasonable person could form a good faith belief that the communications may reveal that the taxpayer sought legal advice in furtherance of filing fraudulent tax returns. But, to make ultimate showing that the crime-fraud exception applies, a higher quantum of proof is required.[16] The Court in *Zolin* declined to specify the level of proof required to establish the crime-fraud exception. Therefore, the court in *Adams* looked for guidance in *Triple Five of Minnesota, Inc. v. Simon*,[17] which identified a two-part test for determining whether a sufficient showing was made. First, there must be a *prima facie* showing that the client was engaged in criminal or fraudulent conduct when he sought the advice of counsel, that he was planning such conduct when he sought the advice of counsel, or that he committed a crime or fraud subsequent to receiving the benefit of counsel's advice. Second, there must be a showing that the attorney's assistance was obtained in furtherance of the criminal or fraudulent activity or was closely related to it.[18]

Although the government met the threshold for reasonable cause, it failed to make the ultimate showing that the crime-fraud exception applied. The mere fact that a privileged communication may help the prosecution prove its case against the defendant is not enough to trigger application of the exception. Moreover, the mere fact that the attorney-client communication may help prove that a crime or fraud occurred does not mean that it was used in perpetrating the crime or fraud. Rather, the communication must be made in furtherance of the alleged crime.

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15 *Zolin*, 491 U.S. at 572; *In re Green Grand Jury Proceedings*, 492 F.2d at 982.

16 *In re Gen. Motors Corp.*, 153 F.3d 714, 716 (8th Cir. 1998) (noting the Supreme Court in *Zolin*, 491 U.S. at 563).

17 *Triple Five of Minnesota, Inc. v. Simon*, 213 F.R.D. 324, 326–27 (D. Minn. 2002).

18 *Id.*

I.R.S. ADDS NEW ISSUES OF FOCUS FOR CROSS-BORDER AUDITS

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Tags
Cross-Border Business
F.A.T.C.A.
Foreign Tax Credit
LB&I

On October 30, 2018, the I.R.S. Large Business and International Division ("LB&I") announced the approval of five additional compliance campaigns.

First announced in January 2017, the "campaign" audit strategy is an issues-based approach to examinations, aimed at identifying issues of large businesses and cross-border activities that pose the greatest compliance risk. Since the initial 13 campaigns were introduced,[1] 32 additional campaigns were approved by LB&I.

The five additional campaigns are the following:

INDIVIDUAL FOREIGN TAX CREDIT

Subject to limitations and certain requirements, Code §901 provides relief from double taxation through a credit against U.S. tax on foreign-source income in the amount of foreign taxes paid on that income.

This campaign addresses taxpayers who have claimed a foreign tax credit but do not meet the requirements. The I.R.S. will address noncompliance through a variety of treatment streams, including examinations.

OFFSHORE SERVICE PROVIDERS

The focus of this campaign is U.S. taxpayers who engaged offshore service providers to create foreign entities and tiered structures to conceal the U.S. beneficial ownership of foreign financial accounts and assets, generally, for the purpose of tax avoidance or evasion. The treatment stream for this campaign will be issue-based examinations.

F.A.T.C.A. FILING ACCURACY

The Foreign Account Tax Compliance Act ("F.A.T.C.A.") was enacted in 2010 to detect, deter, and discourage offshore tax abuses through increased transparency, enhanced reporting, and strong sanctions that apply not only to U.S. taxpayers but also to Foreign Financial Institutions ("F.F.I.'s"). Under F.A.T.C.A., F.F.I.'s and certain Non-Financial Foreign Entities ("N.F.F.E.'s") are generally required to report accounts held by U.S. persons and by foreign persons with substantial U.S. owners.

This campaign addresses those entities that have F.A.T.C.A. reporting obligations but do not meet all their compliance responsibilities. The I.R.S. will address

[1] "I.R.S. LB&I Announces 13 New 'Campaigns' for Audit Guidance," *Insights* 4, no. 3 (2017).

noncompliance through a variety of treatment streams, including termination of F.A.T.C.A. status.

FORM 1120-F DELINQUENT RETURNS

Foreign corporations engaged, or considered to be engaged, in a U.S. trade or business must file a true and accurate Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, on a timely basis. Filing Form 1120-F allows foreign corporations to claim deductions and credits against its U.S. effectively connected income and be taxed on a net basis. Form 1120-F is generally considered to be timely if it is filed no later than 18 months after the due date of the current year's return. Under Treasury Regulations, in certain circumstances where the foreign corporation establishes to the satisfaction of the I.R.S. that it acted reasonably and in good faith in failing to timely file the return, the filing deadline may be waived. In February 2018, LB&I established procedures to ensure waiver requests are applied in a fair, consistent, and timely manner under the regulations.

"The objective of this campaign is to encourage foreign corporations to timely file Forms 1120-F and address the compliance risk for delinquent returns."

The objective of this campaign is to encourage foreign corporations to timely file Forms 1120-F and address the compliance risk for delinquent returns. This is accomplished by field examinations and external education outreach programs.

WORK OPPORTUNITY TAX CREDIT

This campaign addresses the consequences of a delay in issuing a Work Opportunity Tax Credit ("W.O.T.C.") certifications and the burden of the requirement to file amended Federal and state tax returns to claim a W.O.T.C. This burden on taxpayers, coupled with any resulting I.R.S. examinations of the amended returns, is an inefficient use of both taxpayer and I.R.S. resources.

The W.O.T.C. year of credit eligibility issue has been added to the Industry Issue Resolution ("I.I.R.") program. The intention is to provide remedies that reduce the burden on taxpayers, promote consistency, and decrease examination time in order to more effectively use I.R.S. resources.

The objective of the campaign is for LB&I to collaborate with other I.R.S. divisions and with industry stakeholders to develop a directive for taxpayers experiencing late certifications and to promote consistency in the examinations of W.O.T.C. claims.

MIRROR, MIRROR, ON THE WALL, WHICH IS MY TAX HOME OF THEM ALL? – FOREIGN STUDENTS FACE DILEMMA IN THE U.S.

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Tags
Code §162
Foreign Students
Pursuit of Business
Tax Home
Travel Expenses

INTRODUCTION

Not all is exciting when a foreign student gets a job offer from a U.S. employer under the Summer Work Travel Program administered by the U.S. Department of State. While the student is busy getting his or her ducks in a row, he or she should not forget about the tax nitty-gritty of arriving and working in the U.S. This article discusses the deductibility of travel expenses incurred by a foreign student who arrives in the U.S. on a J-1 visa under the Summer Work Travel Program.

THE TRI-F(A)CTA FOR THE TRAVEL EXPENSE DEDUCTION

The U.S. Department of State administers the Exchange Visitor Program, which designates sponsors to provide foreign nationals with opportunities to participate in educational and cultural programs in the U.S. and return home to share their experiences. One component of the Exchange Visitor Program is the Summer Work Travel Program (the "Program"), which provides foreign students with the opportunity to work in the U.S. Foreign students must apply for a J-1 visa to enter the U.S. and work under the Program.

Generally, a foreign individual employed and performing personal services within the U.S. is considered to be engaged in a U.S. trade or business and is, therefore, subject to U.S. Federal income tax.[1] A nonresident alien individual who is temporarily present in the U.S. under an F or J visa, and who otherwise is not engaged in a trade or business in the U.S., is nevertheless deemed to be engaged in a trade or business in the U.S. during the tax year.[2] Accordingly, income earned by foreign students while working in the U.S. under the Program is subject to U.S. Federal income tax. However, the U.S. has entered into tax treaties with several countries that offer tax benefits to J-1 visa holders. For example, a student or business apprentice may be exempt from tax on wages received while studying or training up to an annual dollar limit,[3] and a teacher or a research scholar may be exempt from tax on all of their wage income paid by a U.S. educational or research institution for up to two years. These exemptions are subject to

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1 Code §864(b) (an exception applies to the performance of services for a foreign employer for not more than 90 days in the aggregate throughout a taxable year and compensation not exceeding $3,000 in the aggregate); Code §871(b)(1).

2 Treas. Reg. §1.871-9(a).

3 *E.g.*, Article 21(1) of the U.S.-France Income Tax Treaty (exclusion of up to $5,000 of compensation for a foreign student). An exception under domestic law is limited to holders of F, J, and Q visas and is subject to the condition that the student must be paid by a foreign employer (Code §872(b)(3)).

several conditions. Where these exemptions are not available, the Code also offers several deductions that, in turn, reduce the tax liability. Among other deductions, the Code allows a deduction if the expense meets three conditions:

- It is ordinary and necessary and is incurred in carrying on any trade or business.
- It is incurred while away from home.
- It is incurred in the pursuit of a trade or business.[4]

“A taxpayer's 'home' is his or her 'principal place of business or employment.'”

As mentioned above, a foreign student providing personal services in the U.S. usually satisfies the first condition of “carrying on a U.S. trade or business.” Travel expenses usually meet the “ordinary and necessary” test.

Recently, in the case of *Richard Liljeberg v. Commr.*,[5] the U.S. Court of Appeals for the District of Columbia Circuit discussed the second and the third conditions of Code §162(a)(2) in the context of three non-U.S. citizens students who visited and worked in the U.S. for few months under the Program.

The students entered the U.S. on J-1 visas. They incurred travel expenses, which included airfare to and from the U.S. to their respective home countries, the cost of the Program, visa costs, and insurance. The students reported their wages on U.S. Federal income tax returns and also deducted the travel expenses on the grounds that they incurred the expenses while they were away from home in the pursuit of a U.S. trade or business.

At a first glance, the word “home” in the phrase “away from home” (under the second condition) may be understood as the employee’s place of residence. However, the I.R.S., the Tax Court, and the majority of U.S. circuit courts have adopted the position that a taxpayer’s “home” is his or her “principal place of business or employment.”[6] The interpretation is based on the premise that an average taxpayer maintains a home close to his place of employment.[7] Thus, taxpayers who incur travel expenses because they maintain their residence at a place other than their principal place of business is ineligible to deduct these expenses.

In *Richard Liljeberg*, the court interpreted the word “home” used in Code §162(a)(2) in the same manner. The issue at the heart of the case was the foreign students’ location, for tax purposes, during the Program. If their foreign homes were their tax homes, then the “away from home” requirement would be satisfied and the travel expenses would be deductible. However, if their summer job sites in the U.S. constituted their tax homes, then they were not away from home and could not deduct the expenses. The court held that the students were not “away from home” because they lacked a business reason to maintain a distant, separate residence away from their principal place of employment and so could not claim a personal residence as

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4 Code §162(a)(2).

5 No. 17-1204 (D.C. Cir. Nov. 2, 2018).

6 Revenue Ruling 63-82. However, a few courts have held that “home” means a taxpayer’s usual residence. In *Rosenspan v. U.S.*, 438 F.2d 905, 911-12 (2d Cir. 1971), the Second Circuit concluded that “when Congress uses such a non-technical word in a tax statute, presumably it wants administrators and courts to read it in the way that ordinary people would understand.”

7 *Bixler v. Commr.*, 5 B.T.A. 1181, 1184 (1927).

a tax home. Further, the students did not have any business connections with their respective home countries (none of them where employed) and, therefore, could not have been away from home. The fact that their J-1 visas required them to keep a foreign residence did not mean their foreign residence qualified as a home for tax purposes, as the immigration law did not specifically require them to keep a second home in their home country.

Further, the court also held that failure to satisfy any one of the three conditions jeopardizes the travel expense deduction under Code §162(a)(2). Thus, even if the students were away from home, the travel expenses would be deductible only if the "in pursuit of business" requirement was met. This requirement is satisfied only when the employer's business forces the taxpayer to travel and to live temporarily at some place other than their usual residence to advance the interests of the employer. The exigencies of the business, rather than the personal conveniences and necessities of the traveler, are the motivating factors.[8]

The court referred to *Flowers*[9] and observed that the third condition requires a direct connection between the expenditure and the carrying on of the taxpayer's or the employer's trade or business. Expenses incurred solely as the result of the taxpayer's desire to maintain a home in one place while working in another are irrelevant to the maintenance of the employer's business. In the case of the foreign students, the court held that the U.S. employers did not require them to move to the U.S.; rather, the students chose to come to the U.S. to participate in the Program. Therefore, the travel expenses flowed from that personal choice rather than the exigencies of the employers. Consequently, the deduction of the travel expenses incurred in connection with the Program was disallowed.

CONCLUSION

It is sad but true that U.S. tax law can turn the thrill of coming to the U.S. into agony when it comes time to file tax returns. Foreign students may not be able to deduct expenses for travelling to the U.S. under the Program; however, not all is lost in the antagonism between foreign students and the I.R.S.

Foreign students may still be able to claim an exemption on their wages, either up to a certain dollar limit or for a specified period under a relevant tax treaty. Thus, although it may seem a dispensable cost, it may be worthwhile for foreign students to engage the services of a tax professional to ensure they do not leave money on the table.

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8 *Commr. v. Flowers*, 326 U.S. 465, 470 (1946).

9 *Id.*

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Tags
China
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Residency
Tax Home
U.K.

CHANGES IN CHINA'S TAX LAW AFFECT FOREIGN NATIONALS

As of last September, China has begun sharing taxpayer financial information of residents and nonresidents with over 100 countries under the Common Reporting System ("C.R.S."). In addition, on August 31, 2018, China revised its Individual Tax Law ("I.T.L.") and introduced anti-tax avoidance provisions. These provisions are designed to enable tax authorities to tax people who transfer assets in order to evade tax or take advantage of tax havens.

The I.T.L. will affect many foreign nationals living in mainland China (including those that commute to Hong Kong). Currently, China taxes a foreign non-domiciled individual on worldwide income if the individual has resided in mainland China for one year. However, starting on January 1, 2019, individuals who do not have a domicile but reside in China for 183 days or more in a tax year will be considered tax residents. This rule has come under huge criticism, and waivers or exemptions are being sought, particularly for foreign persons recruited under government programs.

It is expected that China will allow certain exceptions to the 183-day test. The law may continue to exempt foreign individuals who spend extended time outside of China. Furthermore, the new 183-day rule may commence only in the sixth year of residency. Nonetheless, foreigners that meet the 183-day test may still be subject to C.R.S. exchange of information.

DRAFT ECONOMIC SUBSTANCE LEGISLATION FOR CROWN DEPENDENCIES

Three Crown Dependencies exist: the Isle of Man in the Irish Sea, the Channel Island of Jersey, and the Channel Island of Guernsey in the English Channel. Crown dependencies are self-governing jurisdictions of the Crown. The U.K. government has the power to pass legislation that affects Crown Dependencies because they are not considered to be sovereign states. Nonetheless, each of the legislative assemblies maintains the power to pass laws that affect them locally.

In late 2018, the Crown Dependencies published draft legislation requiring adequate economic substance for resident companies carrying on certain activities. Once enacted, a company that is resident in one of the three jurisdictions will not be considered to have economic substance in the jurisdiction unless the core activities of the company occur in the jurisdiction, management and direction take place in the jurisdiction, and adequate employees, expenditures, and physical presence exist in the jurisdiction.

Note that management and direction is not the same as management and control. The latter relates merely to the place where the board of directors meet. The former relates to the types of decisions that are made at the meetings of the board of directors. The directors must have sufficient knowledge and expertise, and the decisions must be made at meetings that take place in the Crown Dependency with adequate frequency.

The rules will apply to companies that are resident in a Crown Dependency and that conduct any of the following business activities:

- Banking
- Insurance
- Shipping
- Fund management
- Financing and leasing
- Headquartering
- Operation of a holding company
- Holding intangible property
- Distribution

The open question not yet addressed in the draft legislation is the definition of economic substance once the necessary factors exist. The Crown Dependencies have announced that guidance notes will be issued on this point. If experience with attempts to define economic substance in other jurisdictions holds true, the guidance notes may well resemble an art critic's attempt to define the *Mona Lisa* in "art speak." Many words will be used to describe the obvious without conveying an understanding of the soul of the subject.

FOREIGN EARNED INCOME EXCLUSION DENIED: ABODE WAS IN THE U.S.

A question that arises for clients that work outside the U.S. on a periodic basis is whether the foreign earned income exclusion applies to salary payments. Where a taxpayer is based in a low-tax or no-tax jurisdiction, the exclusion provides more attractive benefits than a foreign tax credit. In *Leuenberger v. Commr.*,[1] the Tax Court was asked to examine whether a military contractor working in Afghanistan qualified for the exclusion. On the basis of existing authority, the court held that the exclusion was not available in the facts presented.

The taxpayer worked full time as an aircraft pilot for Berry Aviation, Inc. He split his time in rotational shifts between the U.S. and Bagram Air Base in Afghanistan. While in Afghanistan, he piloted a Dehaviland DHC-8 aircraft in support of the U.S. Armed Forces. His employment agreement called for him to work for 60 days on in

[1] T.C. Summary Opinion 2018-52.

Afghanistan followed by 60 days off in the U.S. In 2012, the taxpayer worked outside the U.S. for 173 days and in 2013 for 203 days.

When on deployment, the taxpayer was furnished governmental housing, meals, and transportation, among other services. During the petitioner's time in Afghanistan, Bagram Air Base was susceptible to regular hostilities or attacks. He rarely left the base during his stays in Afghanistan and had no investments in that country. In comparison, throughout 2012 and 2013, the taxpayer maintained a residence in the U.S. in Vancouver, Washington. During these years the petitioner had family in the U.S. and owned and registered three vehicles in the State of Washington. Additionally, he had bank accounts at Wells Fargo Bank and maintained brokerage and retirement accounts at First Trust Co. of Onaga, Jackson National Life Insurance Co., and Pershing, LLC. In 2013, the petitioner owned and maintained a residential rental property in Lake Stevens, Washington, and a residential complex in Monroe, Washington.

Citizens of the U.S. are taxed on worldwide income unless a specific exclusion applies. Code §911(a)(1) provides that a qualified individual may elect to exclude foreign earned income, subject to certain limitations. To be a qualified individual, a taxpayer must satisfy two requirements:

- The taxpayer must be an individual whose tax home is in a foreign country.
- The taxpayer must either be a "*bona fide* resident" of one or more foreign countries or be physically present in such country during at least 330 full days in a 12-month period.[2]

As the taxpayer was not a *bona fide* resident of another country, to be a qualified individual for purposes of the exclusion, he was required to meet the tax home and the physical presence requirements. Code §911(d)(3) defines the term "tax home" as an individual's home for purposes of Code §162(a)(2), involving the allowance of deductions for expenses incurred while traveling travel away from "home," *e.g.* on a business trip. For that purpose, a person's tax home is generally considered to be the location of their regular or principal place of employment. Nonetheless, an individual is not treated as having a tax home in a foreign country for any period for which the person's abode is within the U.S. Although the term "abode" is not defined in the statute or the regulations, Tax Court decisions have held that it generally means the country in which the taxpayer has the strongest economic, familial, and personal ties.

"An individual is not treated as having a tax home in a foreign country for any period for which the person's abode is within the U.S."

The facts in the case indicated that the taxpayer performed his work regularly and principally in Afghanistan. The facts also indicated that his abode was within the U.S. because his ties to the U.S. were stronger than his ties to Afghanistan, where he rarely left Bagram Air Force Base. He had no connection with Afghanistan other than the location of his employment. Because the taxpayer did not satisfy the tax home requirement, he did not qualify for the foreign earned income exclusion.

The taxpayer argued that he could not meet the tax home requirement because conditions in Afghanistan were unsafe in light of the ongoing military conflict in the country. In support, the taxpayer pointed out that the statute allows the tax home requirement to be waived when the I.R.S. determines that an individual is required to leave a country because war, civil unrest, or similar adverse conditions preclude

[2] Code §911(d)(1).

the normal conduct of business and, but for those conditions, the individual could be expected to meet the day-count requirements. However, the court determined that the waiver was not applicable in these circumstances. Each year, the I.R.S. publishes a list of countries to which the waiver applies. During the years involved in the case, Afghanistan was not on the list. Even if Afghanistan were listed, the contract between the taxpayer and his employer called for 60 days on assignment in Afghanistan and 60 days off in the U.S. That was the principal reason why the taxpayer was not outside the U.S. for 330 days in any 12-month period.

RESIDENCY CERTIFICATE – FEE INCREASE ANNOUNCED

The user fee for Form 8802 increased from $85 to $185 for non-individual taxpayers on December 1, 2018. Form 8802 is the form used to request residency certification from the I.R.S. In many countries, payments of dividends, interest, and fees made to a U.S. resident are subject to withholding tax at domestic rates unless Form 6166 is issued by the I.R.S., certifying to the tax residence of the U.S. recipient.

Form 8802, *Application for U.S. Residency Certification*, is used to request Form 6166, *Certification of U.S. Tax Residency*, a letter that the applicant may use as proof of U.S. residency when claiming benefits under an income tax treaty or an exemption from a value added tax imposed by a foreign country. Applicants that are fiscally transparent for U.S. Federal tax purposes, such as partnerships, S-corporations, and grantor trusts, may request certification based on the status of their partners, shareholders, owners, or beneficiaries.

Among other requirements, Form 8802 requires the applicant to specify its taxpayer identification number and, in the case of applicants that are fiscally transparent entities, the identification number of each of the applicant's partners, shareholders, owners, or beneficiaries. Form 8802 also requires the applicant to specify the country or countries for which certification is requested. As a result, not all certification letters on Form 6166 are identical.

In Rev. Proc. 2018-50, the I.R.S. announced that the fee due at the time of filing Form 8802 has been increased for applicants that are not individuals. The fee moves from $85 to $185 for applicants other than individuals. The Form 8802 user fee is not refundable except in cases of overpayment due to mathematical error or mistake.

The current fee schedule is as follows:

- **Requests by Individual Applicants.** A user fee of $85.00 per Form 8802 will continue to be charged for a request by an individual applicant, regardless of the number of countries for which certification is requested or the number of tax years to which the certification applies:
- **Requests by Applicants Other Than Individuals.** A user fee of $185.00 per Form 8802 will be charged for a request by each non-individual applicant:
- **Fiscally Transparent Entities.** A partnership, S-corporation, grantor trust, or other fiscally transparent entity will be charged a single $185.00 user fee with respect to all Forms 6166 issued under its EIN, notwithstanding that the

I.R.S. will verify the tax status of each of the partners, owners, or beneficiaries of the entity who have consented to the request for certification:

- **Custodial Accounts.** A custodian requesting certification on behalf of an account holder will continue to be charged a user fee for each account holder tax identification number, with the amount charged based on the status of the account holder as an individual or non-individual applicant:

- **Multiple Requests.** Because any additional requests for Form 6166 submitted by an applicant on a separate Form 8802 will require the payment of an additional $85.00 or $185.00 user fee charge, an applicant is encouraged to include all Form 6166 requests relevant to a single Form 8802 to avoid multiple user fee charges.

Form 8802 may be submitted to the I.R.S. by mail, delivery service, or fax:

- If the form is submitted by mail, it should be addressed to Internal Revenue Service, P.O. Box 71052, Philadelphia, PA 19176-6052.

- If a private delivery service is used, the submission package should be sent to Internal Revenue Service, 2970 Market Street, BLN# 3-E08.123, Philadelphia, PA 19104-5016.

- If the form is submitted by fax, the user fee should be paid first and should be made by electronic payment at the Pay.gov website. The electronic payment confirmation number related to the payment should be inserted on Form 8802. Any of the following fax numbers should be used: (877) 824-9110, if within the U.S., and +1 (304) 707-9792, if inside or outside the U.S.

NEW MULTILATERAL WORKING RELATIONSHIP TARGETS ENABLERS OF TAX FRAUD

The year 2018 saw the establishment of a working group to combat transnational tax crime through increased enforcement collaboration among tax authorities in several countries. The Joint Chiefs of Global Tax Enforcement (known as the J5) was formed to work together to gather information, share intelligence, conduct operations, and build the capacity of tax crime enforcement officials. The J5 comprises the Australian Criminal Intelligence Commission ("A.C.I.C.") and Australian Taxation Office ("A.T.O."), the Canada Revenue Agency ("C.R.A."), the Dutch Fiscale Inlichtingen-en Opsporingsdienst ("F.I.O.D."), U.K. HM Revenue & Customs ("H.M.R.C."), and the U.S. Internal Revenue Service Criminal Investigation ("I.R.S.-C.I.").

The J5 was formed in response to the O.E.C.D.'s call to action for countries to do more to tackle the enablers of tax crime. The J5 works collaboratively with the O.E.C.D. and other countries and organizations where appropriate.

The 2018 annual report of I.R.S.-C.I. contains a statement by Eric Hylton, the Deputy Chief of I.R.S.-C.I.:

> This year, we established a new international tax and financial crime group in our Washington, DC, field office. This dedicated group of elite special agents works to identify, investigate, and recommend

prosecution of international offshore tax evasion schemes. The group looks at U.S. citizen account holders who move their money offshore to avoid detection, and at foreign banks, financial institutions, their employees, and facilitators who help U.S. citizens hide their funds offshore. This operational unit has the ability to work criminal tax cases developed from all international leads sources.

In addition to our international group, IRS CI recently formalized the creation of the Joint Chiefs of Global Tax Enforcement, or the J5. This group includes the heads of tax enforcement from the United States, the United Kingdom, Canada, Australia, and the Netherlands. These countries' leaders recognize the increasing trends in sophisticated tax evasion and other financial crimes that cross international borders, and they are already sharing information and collaborating on investigations.

About Us

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.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

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.

Disclaimer

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