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B.V.I.: CONSULTATION ON ACCESS TO BENEFICIAL OWNERSHIP INFORMATION.

U.S. TAX PLANNING FOR ISRAELI INVESTMENT IN U.S. REAL ESTATE: A TALE OF SCYLLA AND CHARYBDIS

DYNASTY IN THE DETAILS – U.S. ESTATE PLANNING CONSIDERATIONS FOR GLOBAL FAMILIES

AND MORE

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EDITORS' NOTE

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

- **B.V.I.: Consultation on Access to Beneficial Ownership Information.** As of January 2, 2025, a new beneficial ownership reporting regime has come into effect. This regime replaces the previous beneficial ownership reporting framework. New entities must identify and file adequate, accurate, and up-to-date beneficial ownership reports within 30 days of registration Existing Entities have until Julyl 2, 2025, to comply. On January 17, 2025, the B.V.I. Government launched a consultation on a draft policy regarding rights of access to the Register. In line with its commitments, access to information will be granted to persons demonstrating "legitimate interest" to information. The period for responses to the Consultation closes on February 28, 2025. Joshua Mangeot, a partner in the B.V.I. office of Harneys, explains how the new system addresses major issues, including the definition of a "legitimate interest" and circumstances in which disclosure will be viewed as posing a disproportionate serious risk for affected U.B.O.'s.

- **U.S. Tax Planning for Israeli Investment in U.S. Real Estate: A Tale of Scylla and Charybdis.** U.S. real estate remains a favored asset class for foreign investment by Israeli residents. With the Israeli shekel currently being relatively strong against the U.S. dollar, investments in the U.S. have become even more attractive. And while personal use property in cities like Miami and New York City remain a privilege of high net worth individuals, fractional investments in multifamily residential and commercial property have become available to many investors. Whether investing in high end property or in development projects, hidden traps exist. Knowing where they pop up, the ways to best resolve issues in one country without creating problems in the other, and how to manage client expectations while maneuvering between the "Scylla" and "Charybdis" of the laws of each country requires the experience of an Odysseus. Galia Antebi takes a deep dive into the planning alternatives that are available, identifying the pluses and minuses of each alternative.

- **Dynasty in the Details – U.S. Estate Planning Considerations for Global Families.** In the United States, creating "dynasty trusts" has become common planning tool for many estate planners. A dynasty trust is a trust that may continue for generations. If done well, it provides a myriad of benefits for strategic income, estate and gift tax planning, creditor protection and ensuring family inheritance. Nonetheless, life choices have a way of interfering with preset plans. A beneficiary moves to a different country. A trustee who is a U.S. resident, but not a citizen, decides to move home. A foreign parent of a U.S. spouse wishes to make a gift to the next generation of beneficiaries. These seemingly trivial details could unintentionally cause severe tax and other planning consequences in the U.S. and abroad. Based on her experience, Allison Dolzani leads the reader through a cycle of cross border issues that must be addressed as life progresses.

- **Hooray For New Math: is it Really a Simplified Transfer Pricing Approach for 2025?** As promised before the end of 2024, the I.R.S. has outlined its approach to the codification of Amount B, a component of the O.E.C.D. Pillar One approach to controlled distribution transactions of tangible property. Notice

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2025-04 allows taxpayers to elect to use the streamlined, simplified approach ("S.S.A.") for corporate tax years beginning on or after January 1, 2025. If a valid election is made, the I.R.S. will consider the S.S.A. to be the best method under the Treas. Reg. §1.482-1(c). While touted as a method that brings simplicity to transfer pricing, in practice simplicity is achieved at the price of certain important concepts fundamental to the arm's length standard codified in tax law. Michael Peggs does yeoman's work in taking the reader through the steps to be followed, the conditions to be applied, and the variable values that pop out of the S.S.A. machine. To readers who have given transfer pricing advice over the years, Amount B may seems to be based on concepts of the command economy of bygone days rather than market transactions.

- **Reading Tea Leaves – What May be In Store for Tax Legislation.** President Trump made several tax proposals in the course of his winning campaign for the White House. In her article, Nina Krauthamer lists proposals made by the President and the likely responses of Democrats in Congress followed by a general analysis of various positions. What becomes clear is that when political parties are in power, proposals to spend money are plentiful. Yet, when they are voted out of office, the same parties object to every tax cut as ultimately being profligate.

- **Another Taxpayer Allowed Treaty-Based Foreign Tax Credit Against N.I.I.T.** The application of the foreign tax credit to the net investment income tax ("N.I.I.T.") has been a recurring battle in courtrooms in recent years. In the most recent installment, the taxpayer in *Bruyea v. U.S.* prevailed in claiming a foreign tax credit under the Canada-U.S. income tax treaty. The N.I.I.T. is a 3.8% tax on certain items of passive income that is levied on U.S. individuals whose gross income is above certain thresholds. The position of the I.R.S. is that the foreign tax credit cannot be claimed to reduce the amount of N.I.I.T. that is due. In the facts of the case, the Canada-U.S. Income Tax Treaty clearly provided that the foreign tax credit applies to all U.S. taxes based on income whether in existence at the time the treaty came into force and effect or afterwards. Wooyoung Lee explains all.

- **Corporate Matters: Ending a Business Relationship – a Time Consuming and Drawn-Out Process.** Often the realities of a business arrangement can be quite different than a plan conceived between optimistic partners. Market conditions can change, and commitments made can become difficult to deliver, sometimes through no lack of trying. As business attorneys, we have seen situations where one partner brings technical and production know-how, and another brings the promise of market introductions and sales contacts. In an article based on many years of practice, Simon Prisk advises that breaking up a business partnership can be difficult and emotional. If the organizational documents are simply taken from a form book, the partners will face a time of uncertainty as off-the-shelf documents rarely provide helpful solutions.

- **Updates & Other Tidbits.** This month, Tidbits returns to *Insights*. One tidbit addresses the on-again / off-again status of the Corporate Transparency Act. A second tidbit addresses a rare win for an individual who challenged taxation at the state level.

We hope you enjoy this issue.

- The Editors

B.V.I.: BENEFICIAL OWNERSHIP REPORTING AND CONSULTATION ON ACCESS TO BENEFICIAL OWNERSHIP INFORMATION

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Tags
Access
Beneficial Ownership Register
B.V.I.
B.O.I.

Joshua Mangeot is a partner in the B.V.I. office of Harneys. His practice includes advising HNWIs and MNEs on a broad range of corporate, finance, transactional, regulatory, and tax matters. Josh is regarded as a leading specialist on the implementation of the B.V.I. economic substance requirements.

INTRODUCTION

In an article published in *Insights* last year,[1] selected developments in regulatory and tax-related law and practice that affect end-clients, advisors and intermediaries were surveyed in the British Virgin Islands ("B.V.I."), Cayman Islands and Bermuda. In the period since that article was published, amendments to the B.V.I. beneficial ownership regime have come into force and the B.V.I. Government has issued a consultation document (the "Consultation") regarding rights of access to the beneficial ownership register. As part of the process, comments were requested from the public. The period for responses to the Consultation closes on February 28, 2025.[2]

This article provides an overview of the key changes under the new regime, and highlights important aspects of the ongoing consultation process.

OVERVIEW

As of January 2, 2025, a new beneficial ownership reporting regime under the B.V.I. Business Companies and Limited Partnerships (Beneficial Ownership) Regulations, 2024 (the "Regulations") has come into effect. This regime replaces the previous beneficial ownership reporting framework under the Beneficial Ownership Secure Search System Act, 2017 ("B.O.S.S. Act"), although that Act has not yet been repealed. The new regulations aim to enhance transparency while maintaining the B.V.I.'s reputation as a leading international financial center.

These changes have been expected for some time. Amendments were previously announced to the BVI Business Companies Act, Revised Edition 2020 (as amended, the "B.C. Act") and the Limited Partnership Act, Revised Edition 2020 (as amended, the "L.P. Act"). Those amendments are now in force and the Regulations promulgated under the B.C. Act and the L.P. Act provide the details of the new regime. The amendments and Regulations create a centralized Register of Beneficial Ownership administered by the Registrar of Corporate Affairs (the "Registrar"), which is a division of the B.V.I. Financial Services Commission ("F.S.C.").

Broadly, the regime applies to all companies or limited partnerships registered in the B.V.I. ("Entities"), although certain exemptions are available. Transitional periods of at least six months apply to Entities registered in the B.V.I. prior to January 2, 2025, ("Existing Entities"). As companies limited by shares incorporated under the B.C. Act are by far the most popular B.V.I. corporate entity, this update deals only with those companies unless otherwise stated.

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1 Joshua Mangeot, "The B.V.I., Cayman Islands, and Bermuda – Current practice, Enforcement, and Emerging Trends," *Insights* Vol. 11, No. 6, p.68 (2024).

2 Available here.

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On January 17, 2025, the B.V.I. Government launched a consultation on a draft policy regarding rights of access to the Register. In line with commitments made by other United Kingdom Overseas Territories, this policy proposes a framework for granting access to certain beneficial ownership information ("B.O.I.") to persons demonstrating "legitimate interest" regarding information. At the same time, it seeks to balance transparency with privacy and security concerns.

There will be no legitimate interest access until the Consultation concludes and further legislation has been passed implementing the final policy. Based on public commitments made by the B.V.I., Bermuda and Cayman to the United Kingdom, final legislation is expected to be published in April, with implementation by the end of June 2025.

FILING AND DEADLINES

Broadly, new Entities must identify and file with the Registrar adequate, accurate, and up-to-date B.O.I. reports as prescribed by the Regulations. Reports are due within 30 days of registration in the B.V.I., including on continuation into the B.V.I. Existing Entities have until Julyl 2, 2025, to comply, benefiting from the six-month transitional period mentioned above. Any future changes to the B.O.I. must be reported within 30 days from the date the Entity first became aware of the change.

The information must be filed by the Entity's registered agent via the F.S.C.'s electronic V.I.R.R.G.I.N. platform, which is replacing the B.O.S.S. system for B.O.I. filings.

BENEFICIAL OWNERS

The regime is concerned with ultimate beneficial owners ("U.B.O."). A "beneficial owner" is broadly defined as a natural person who ultimately owns or controls 10% or more of the relevant Entity or exercises control over its management (a "10%+ U.B.O."). This definition encompasses both ownership and control and so includes legal ownership, economic ownership, and voting rights. The 10% threshold is consistent with the B.V.I.'s robust approach to anti-money laundering regulation.

However, only certain specified B.O.I. on ultimate beneficial owners with a 25% or greater interest (each, a "25%+ U.B.O.") is expected to be accessible to persons demonstrating a legitimate interest 25%+ is the usual threshold for reporting under global standards. Other information filed pursuant to the B.C. Act and L.P. Act on 10%+ U.B.O.s under the Regulations will remain accessible exclusively to competent authorities and law enforcement agencies in the B.V.I.

EXEMPTIONS

Certain Entities are exempt from filing B.O.I. but must still notify their status to the Registrar and provide basic details. Broadly, these include

- entities with shares listed on a "recognized stock exchange," which includes all the leading global stock markets;
- all B.V.I. regulated investment fund vehicles and any company whose shares are held by a trustee licensed under the Banks and Trust Companies Act,

Revised Edition 2020 (as amended, the "B.T.C.A."), in each case provided that the B.O.I. (i) is maintained by B.V.I. regulated administrator or an authorized representative or other person licensed by the F.S.C. with a physical presence in the B.V.I. and (ii) can be provided with 24 hours of request; and

- an Entity that is at least 75% owned by another Entity that complies with the beneficial ownership filing requirements or is itself exempt, thereby avoiding duplication of reporting where a chain of B.V.I. Entities exists.

Companies subject to disclosure and transparency rules contained in international standards, equivalent to those for listed companies or specified funds, may apply for exemption.

GOVERNMENT CONSULTATION

The Consultation sets out the B.V.I. Government's policy for allowing access to certain B.O.I. based on the concept of "legitimate interest." The Government recognizes that this is a question of significant interest in the B.V.I. and throughout the global financial services industry. The policy seeks to balance transparency and privacy by allowing specific stakeholders that demonstrate a legitimate interest to access information in defined circumstances, while protecting the safety and security of vulnerable individuals and sensitive personal data.

"Companies subject to disclosure and transparency rules contained in international standards, equivalent to those for listed companies or specified funds, may apply for exemption."

The policy is subject to consultation and there is a list of questions to industry participants set out in the Appendix to the Consultation.

In summary, the draft policy addresses the following points:

- It broadly defines the concept of "legitimate interest" as a demonstrable, specific, and lawful need to access information to investigate, prevent, or detect serious financial crime or to assist in ongoing legal proceedings or regulatory investigations related to the same.
- It specifies circumstances in which legitimate interest or a person's connection with an Entity or its U.B.O. may be claimed.
- It sets out categories of entities that may apply for access to the Register by demonstrating a legitimate interest, which must be directly related and proportionate to the purpose for which it is to be used.

To protect vulnerable individuals, exemptions are proposed to be granted in circumstances where

- the disclosure poses disproportionate serious risks to the U.B.O. or any individual,
- the request for disclosure relates to minors or legally incapacitated persons, or
- the Registrar determines that disclosure is against public interest.

Applications for exemptions must be submitted by the U.B.O. or a legal representative to the Registrar and must include supporting evidence. Any U.B.O. who considers that such an application may be appropriate may wish to start gathering information that supports the application.

Only limited details are expected to be disclosed, such as (i) name, (ii) month and year of birth, (iii) nationality, (iv) country of residence, and (v) nature/extent of beneficial ownership. All information is expected to be restricted to relate to the 25%+ U.B.O.'s.

The policy sets out a process for submission of requests and subsequent review and decision by the Registrar. A mechanism is proposed to notify to the relevant U.B.O. via the Entity's registered agent, so that the U.B.O. has a chance to object to release of information.

As would be expected, the policy envisions a robust framework to preserve confidentiality and data security and to allow for appeals to the Financial Services Appeal Board. The Registrar is also required to keep a record of all access requests and there are fines and other civil and criminal penalties for misuse, including the provision of false or misleading information.

PRACTICAL CONSIDERATIONS

Entities and their advisors and registered agents should take steps to ensure compliance with the new regime, such as the following:

- Ensuring new Entities comply with the new requirements and that Existing Entities will be compliant before July 2, 2025.
- Considering whether an Entity qualifies for exemption or is subject to the B.O.I. reporting requirements.
- Conducting internal reviews to identify 10%+ U.B.O.s and to ensure that any changes can be identified.
- Updating and maintaining records to ensure accuracy and completeness, gathering the B.O.I. required, and maintaining records that demonstrate the steps taken to gather the information.
- Seeking appropriate advice where (i) uncertainty exists regarding their obligations or (ii) difficulties are encountered in identifying U.B.O.s or obtaining the necessary information.
- Taking steps to seek exemption or to file objections by persons concerned (i) with violations of their rights to privacy, (ii) with risks that may arise from disclosure, or (iii) with risks to vulnerable, minors, or incapacitated individuals.

It is expected that registered agents will be contacting their clients to confirm existing B.O.I. and gather or verify the details required under the new regime.

Industry participants are also encouraged to participate in the consultation process by submitting feedback on the Consultation and the policy questions raised by Government. Feedback can be submitted via email to boconsultation@gov.vg by February 28, 2025.

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CONCLUSION

The updates to the B.V.I.'s beneficial ownership reporting regime demonstrates the commitment of the B.V.I. to global standards in the fight against financial crime, while balancing transparency with individuals' rights to privacy and protection from harm.

The ongoing consultation provides an opportunity for stakeholders to shape future policy in this area. Clients and industry participants are encouraged to engage in this process to ensure that any concerns regarding privacy, security, and operational impact are addressed.

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U.S. TAX PLANNING FOR ISRAELI INVESTMENT IN U.S. REAL ESTATE: A TALE OF SCYLLA AND CHARYBDIS

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Tags
Family Company
Israeli Investor
Pierre v. Commr.
Rev. Rul. 55-701
U.S. Real Property
U.S. Situs Asset

INTRODUCTION

U.S. real estate remains a favored asset class for foreign investment by Israeli residents. With the Israeli shekel currently being relatively strong against the U.S. dollar, investments in the U.S. have become even more attractive. And while personal use property in cities like Miami and New York City remain a privilege of high net worth individuals, fractional investments in multifamily residential and commercial property have become available to many investors.

Many entrepreneurs are active in the field and offer "friends and family" to participate with as little as a $50,000 investment. Typically, there is an Israeli living in the U.S. who forms a limited liability company ("L.L.C.") that is formed to invest in a certain property, with that individual as the manager, and the investors participate as members of the L.L.C.

Often, the entrepreneur shows the investors the expected yield of return, but may fail to mention the risk of U.S. estate tax. Some investors believe that because they do not own the real estate directly, they will not face the exposure, and hope that the manager of the L.L.C. will simply transfer their interest in the L.L.C. to their heirs. They assume that since no deed recording will be needed, the issue will not come up. Not only is that not the law and not recommended by any competent U.S. tax adviser, but also, it is good to remind those investors that their plan only works if the L.L.C. manager agrees to be noncompliant with U.S. tax law, and that hardly seems an appropriate plan.

Those who realize the risk and want to plan, soon realize that a "perfect" structure may not exist when trying to be compliant in both the U.S. and Israel. Also, at times, after several years of successfully investing in the U.S. with the same entrepreneur, the investor may be invited to the table, and becomes more involved. It may be by way of organizing others to invest, or by advising or otherwise assisting the entrepreneur in relation to the investments, financing, etc. Even if not compensated, this involvement may affect the tax treatment of the L.L.C. Additionally, if the compensation is structured differently than added profit share, it may complicate the tax position of the investor.

This article tackles the key challenges and offers possible structures for Israeli investors to consider in order to optimize their U.S. real estate investments.

DIRECT OWNERSHIP + SPLITTING THE INVESTMENT BETWEEN DEBT AND EQUITY

This assumes an equity investment in the L.L.C. as well as execution of a debt instrument by the L.L.C. to the same investor, which is introduced as a partial protection

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from estate tax. While the loan must not be participating, and therefore limits the upside, and the investment in equity must grant the investor less than 10% of the capital and profits in the L.L.C., the benefit of such bifurcation is that as long as the debt qualifies as "portfolio debt," it will not be subject to U.S. estate tax. The equity investment remains exposed to estate tax if the investors total investment in all U.S. situs assets is valued at more than $60,000 at death.

From a U.S. perspective, the Israeli investor is a member of an L.L.C. and is expected to receive a Schedule K-1 annually from the L.L.C. That is the I.R.S. form that will report his or her share of the income, deductions, etc. The investor is required to file a U.S. tax return annually based on the L.L.C. results shown on the Schedule K-1. To do that, the investor must obtain a tax I.D. The investor will pay U.S. income tax on the net rental income, typically through quarterly withholding taxes paid by the L.L.C., as well as on the profit from the ultimate sale of the property, in the manner set forth in the L.L.C. agreement, often in proportion to such investor's equity in the L.L.C. This profit is also subject to withholding. The collection of withholding taxes, on quarterly basis and upon sale, does not excuse a non-U.S. member of the L.L.C. from his or her U.S. tax return filing obligation. Rental income is taxed as ordinary income, at graduated rates up to 37% Federally for an individual taxpayer. State and local tax may also apply. After depreciation deduction is claimed, as well as other expenses such as real estate taxes and insurance, often there in no taxable income for the duration of the investment, which typically is between three and seven years. Capital gain is taxed to individuals at up to 20% Federally (state and local tax may also apply), but any gain measured by the reduced basis attributable to depreciation deductions claimed over the years is taxed at 25% Federally.

Most, if not all, investors assume that the amount received from the L.L.C.'s sale of property will be treated as capital gain, which is taxed favorably in the U.S. (either at 20% or 25% as mentioned above). However, if the L.L.C. is engaged in a U.S. trade or business, and the sale of the property is attributable to such trade or business, (for example, construction and sale of units in a condominium building), the profit may be taxed as ordinary income rather than capital gain, even if the investor is a passive investor. This is because the character of the income and profit earned by an L.L.C. is determined at the L.L.C. level and if the L.L.C. is engaged in building units that are for sale to customers in the ordinary course of business, all profits are treated as business income.

Even when the property is held for rental, any plan that contemplates a sale of the rental structure from the outset may lose its character as property held for investment and rental business and may convert the treatment of the sale proceeds from capital gains to ordinary business income. The risk often arises because the manager of the project has a history of "build and flip." Just because an L.L.C. has rental income does not necessarily mean the L.L.C. is solely engaged in the rental business. Being so engaged will not "ruin" the capital gain nature of the profit. When the purpose of the investment is "buy to sell," a risk exists that the gain that is recognized by the L.L.C. may not qualify for favorable capital gain treatment.

Even when the property is held for rental, any plan that contemplates a sale of the rental structure from the outset may lose its character as property held for use in the rental business. The risk often arises because the manager of the project has a history of "build and flip." Just because an L.L.C. has rental income does not necessarily mean the L.L.C. is solely engaged in the rental business. Hence a risk exists that the gain that is recognized by the L.L.C. may not qualify for favorable capital gain treatment.

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The rules under the Foreign Investment in Real Property Act ("F.I.R.P.T.A.") will apply to the equity investment portion only. This will result in withholding with respect to the disposition of the underlying property by the L.L.C. as well the sale of the L.L.C. interest itself. Additionally, since an L.L.C. is generally taxed as a partnership, the regular withholding rules applicable to U.S. partnerships having foreign partners will also apply. As a result, these withholding rules may at times compete with the F.I.R.P.T.A. withholding rules, and regulations prevent double withholding and address which of the rules prevail in the circumstances of the L.L.C. and its business.

As long as the "portfolio indebtedness" requirements are met (which is required in order for the instrument to be exempt from U.S. estate tax), the interest paid on this instrument will not be subject to U.S. income tax.

Advantages

Direct ownership is simple and avoids complex entity structures. Due to the L.L.C. being used, some confidentiality for the investor remains, subject to other member-investors' visibility. Bifurcating the investment and using debt reduces the amount of value exposed to U.S. estate tax.

Challenges

For the debt portion to qualify as "portfolio debt," the investor cannot be viewed as the owner of 10% or more of the equity in the L.L.C. and the interest payments cannot be contingent on profits. The challenge therefore is to manage the risks. One principal risk involves the application of the attribution rules. These rules cause an individual to be considered to own the L.L.C. interest of another member. This may occur when family members invest in the L.L.C.

Subject to a $60,000 exemption, the equity portion is exposed to U.S. estate taxes. Estate taxes are levied at rates of up to 40%. Term life insurance can be purchased to protect against such exposure, if the investor is insurable. Annual filing may be burdensome, and withholding often results in excess tax paid and can affect cashflow.

The Israeli Aspect

Israel generally treats the L.L.C. as an opaque entity. Initially, an investor can notify the tax authorities if he or she wishes to treat it as a passthrough, however even if such election is made, the L.L.C. is a passthrough only for certain purposes.

An opaque L.L.C. raises a risk of "management and control" existing in Israel, which would subject the L.L.C. to corporate tax levels in Israel in addition to the U.S. Double taxation is a distinct possibility. Management and control can be a risk if the entrepreneur who manages the L.L.C. lives in Israel, a fact that can change during the life of an investment, or if the investors that were invited to the table get involved in decision making. In any event, since the U.S. has the undisputable first right to tax when U.S. real property is the asset held by the L.L.C., and because Israel will recognize the U.S. taxes paid by the investor as paid by the L.L.C., the exposure to double taxation for the L.L.C. is practically eliminated and typically concludes with the added couple of points of tax due to Israel.

However, for the investor, the situation is different, and an opaque treatment for the L.L.C. may result in significant double taxation. This is because the U.S. tax paid by the investor will not be creditable in Israel for the investor. When a distribution is made, Israel will tax the investor again for what it views as dividend income, currently taxed at 25% up to a not-so-high certain threshold and 30% thereafter.

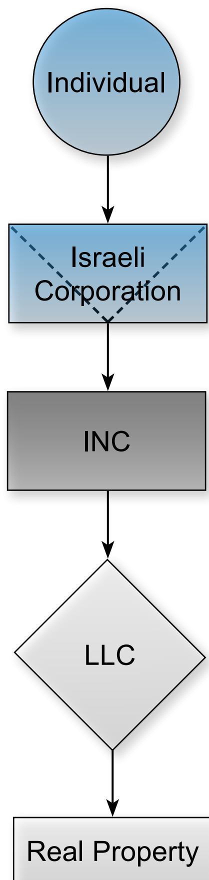
In comparison, if an election for passthrough treatment in Israel is made with regard to the L.L.C., the situation is better, because the U.S. tax paid is creditable, and capital gain treatment (to extent available) flows through. As a result, upon a sale, the investor will pay 20% Federal tax, as well as potentially some State tax, and both those taxes will be creditable against the Israeli tax of 25% - 30%, resulting in potentially little or no additional Israeli tax.

With respect to rental income, this is generally taxed as business income in Israel when it flows through from an L.L.C. Therefore, the income would be taxed at graduated rates of up to 50% with credit for any U.S. tax paid.

The drawback of the L.L.C. – even if an Israeli tax election is in place – is the fact that it is only partially tax transparent, meaning, losses do not flow through. Therefore, if an investor invests in more than one L.L.C. at the same time, and one produces losses but the other gains, Israel will not allow an individual to pool the results of the several L.L.C.'s. Tax will be due in Israel with respect to the profitable L.L.C.'s without any offset for the losses of other L.L.C.'s. For that reason, Israelis who invest in more than one L.L.C. generally prefer the use of U.S. partnerships over L.L.C.'s, because Israel recognizes foreign partnerships as true tax transparent entities.

Lastly, Israel does not allow local tax to be credited. Consequently, New York State tax will be creditable, but New York City tax will not.

OWNERSHIP THROUGH A TWO-TIER CORPORATE STRUCTURE WHERE THE UPPER TIER ENTITY IS AN ISRAELI "FAMILY COMPANY"



In General

When investors recognize that their U.S. profits will be taxed as ordinary income because the real estate investment is made in a development project, they often consider using a U.S. corporation. This is because the U.S. corporate tax rate is relatively low, 21% at the Federal level. This compares to rates of up to 37% when individuals are involved. In addition, State and Local taxes will apply to both individuals and corporations and the differences in individual and corporate tax rates generally often are not of the same magnitude. Dividend distributions from the U.S. will be taxed at the rate of 25% under the terms of the existing Israel-U.S. Income Tax Treaty (the "Treaty") if the shareholder is an Israeli resident individual, but only at a 12.5% rate if the shareholder is an Israeli corporation owning least 10% of the U.S. corporation. The two levels of tax result in approximately 40% Federal taxes in the U.S. if the individual rate is taken into account.

When the Israeli company used as the upper-tier entity is a Family Company, discussed more in detail below, the U.S. will apply the Treaty in a way that recognizes the Israeli look through treatment and essentially grant the Treaty benefits to the individual, thus subjecting the dividend to a 25% tax. If a regular Israeli company is used, the total effective rate of U.S. Federal tax may be lower, approximately 30% (only 12.5% will be imposed on the after tax earnings). However, Israel will tax dividends paid by the Israeli company at a rate that varies between 25% and 30%. Consequently, a Family Company is most often used.

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An additional U.S. tax benefit that is derived from the use of an upper-tier corporation is that it protects the ultimate beneficial owner from U.S. estate tax on his share of the value of the U.S. corporation. Ownership of a U.S. corporation by an Israeli resident individual is subject to the same exposure to estate tax as direct ownership of U.S. real property.

Because the owner of the real estate is a U.S. corporation, no F.I.R.P.T.A. tax is imposed on the gain derived from the disposition of the underlying property. In addition, no branch profits tax ("B.P.T.") applies to the Israeli company in connection with the sale of shares of a U.S. corporation. B.P.T. is discussed in more details below where investment through an Israeli corporation is discussed.

Advantages

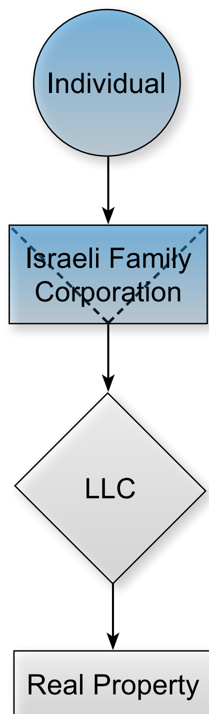
If the project is structured to generate ordinary income for an Israeli investor, it may be preferable to have the U.S. tax imposed at lower corporate rates, and to have the U.S. corporation reinvest the after-tax excess cash in additional real estate projects in the U.S. Additionally, if several investments are made, it is possible to offset income in one project with losses in a second project within the U.S. corporation.

Additionally, the investor is able to control the timing of the dividend from the U.S. corporation, which may allow some deferral in both the U.S. and Israel. Lastly, neither the individual nor the Israeli company need to file U.S. tax returns.

Challenges

This structure may be viewed as complex and may have added administrative costs relating to filing. It typically would be considered by investors who invest significant funds in development properties.

OWNERSHIP THROUGH AN ISRAELI FAMILY COMPANY – NO CHECK-THE-BOX ELECTION MADE IN THE U.S.



A Family Company is tax transparent in Israel. All members must be family members, and all have limited liability. Under Israeli tax rules, the income of the company is attributed to one, and only one, of the shareholders and included in his or her tax return. By default, this is the single shareholder having the largest holding, but any shareholder may be elected as the taxpayer. Because all shareholders have limited liability, under default U.S. entity classification rules, the company is treated as a corporation for U.S. tax purposes, unless a check-the-box election is made to change the company's classification for U.S. tax purposes. As a foreign corporation, the stock of the Israeli company would be considered a foreign situs asset that is not subject to U.S. estate tax.

However, this structure results in potentially higher total taxes. As a foreign corporation from a U.S. perspective, income treated as effectively connected income ("E.C.I.") is taxed at a flat corporate rate, currently 21% at the Federal level. The after-tax earnings may be subject to branch profits tax ("B.P.T.") at the applicable rate for dividend income. Note that the tax base for B.P.T. purposes may be higher than for income tax purposes because depreciation deductions may not be as generous when it comes to B.P.T. State and local tax may also apply, and in many states, the corporate rate is higher than the individual rate.

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B.P.T. generally aims to equate the activity of a U.S. branch of a foreign corporation with that of a U.S. corporate subsidiary that pays dividends. In general, the rate of B.P.T. is 30%. However, where the Treaty applies, the rate of B.P.T. is reduced to 12.5% if the company is eligible for benefits. Consequently, if the earnings of a branch increase, but assets remain flat or decrease, business earnings are deemed to have been repatriated. B.P.T. is imposed on the deemed repatriation much like withholding tax imposed on dividend distributions. If on the other hand, the earnings are reinvested in a U.S. business, the tax is deferred. When the U.S. branch sells all its property in the U.S. and distributes the proceeds to its head office, the gain is treated as E.C.I. However, B.P.T. can be eliminated if a complete termination of the U.S. business has occurred and the head office does not reinvest in the U.S. for the balance of the year and for the following three years. The statute of limitations must be extended for the year of the sale from three years to six years.

Where more than one property is acquired by a foreign corporation, or investments are made by a foreign corporation in more than one L.L.C., B.P.T. can apply to the profits from each disposition of property and the exemption mentioned above will not be available until the last property is disposed of. Other exemptions may apply, specifically if the investment was in a U.S. real property holding corporation, a defined term. As mentioned above, B.P.T. equates to a deemed dividend.

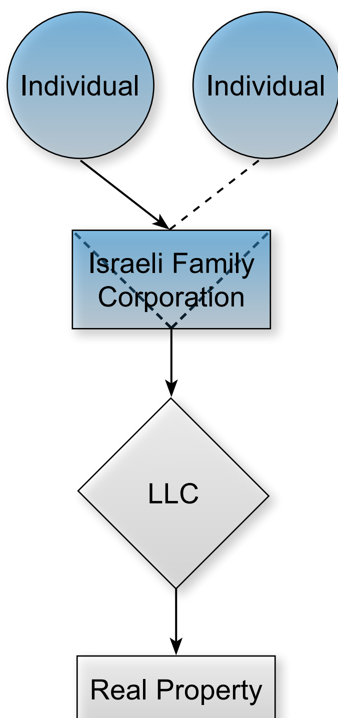
Advantages

This structure allows protection from U.S. estate tax without adding a second level of tax in Israel. Individual shareholders will not be required to file U.S. tax returns and only the Israeli company will.

Challenges

The B.P.T. is not creditable in Israel, and therefore this structure results in relatively high total tax. All other Israeli tax concerns mentioned above, relating to the opaque treatment of the L.L.C. continue to apply.

OWNERSHIP THROUGH AN ISRAELI FAMILY COMPANY – A CHECK-THE-BOX ELECTION IS MADE IN THE U.S.



As mentioned above, the entity classification regulations allow certain entities to elect to change their default tax treatment. As such, a foreign company having limited liability for all its members and which defaults to corporate treatment under I.R.S. regulations can elect to be taxed as a disregarded entity if it has one shareholder or as a partnership if it has two or more shareholders. From an income tax perspective, this would eliminate the B.P.T. Both the U.S. and Israel would view the Israeli company as a passthrough entity for tax purposes. The shareholder or shareholders are treated as receiving all income and profits derived by the L.L.C. As mentioned above, the shareholder or shareholders are also treated as deriving losses for U.S. income tax purposes which may reduce net income or net gain that is subject to tax in the U.S. as E.C.I., however, if the loss was derived in an L.L.C., it may not pass through for Israeli tax purposes.

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Advantages

This structure allows offers some level of estate tax protection (a position; see below) without adding a second level of tax in the U.S. or Israel. If the investor expects capital gain treatment, this structure offers a significant savings on the income tax.

Challenges

The situs of partnership interest is not determined in the Code. And the election to treat a company as a disregarded entity applies for Federal tax purposes, not limited to income tax purposes. As a result, the owner of a disregarded entity is treated as if he or she owns the property. If the owner is a nonresident, noncitizen individual and the property is an L.L.C. that owns U.S. real property, it may be difficult to assume estate tax will not apply. If there are two shareholders to the Israeli company, the election to treat it as a passthrough for U.S. tax purposes would result in partnership treatment. In the context of the ownership of an interest in a partnership, the rules determining the situs of partnership interest are also opaque, although seemingly better than the situs of a disregarded entity as at least a partnership is a regarded entity. For some tax purposes, a partnership is looked at as an entity and for other tax purposes it is looked at as an aggregate of the partners. The most recent I.R.S. revenue ruling regarding estate tax imposed on partnership interest was issued in 1955, concluding that the place where a partnership engages in business controls the situs of the partnership interest. Consequently, a foreign company that is taxed as a partnership and not engaged in a U.S. trade or business arguably is considered a foreign situs asset.

The application of these guidelines to each fact pattern is complex, and while an argument might exist, a risk remains as the structure does not offer the same level of assurance that a foreign corporation offers. This includes a Family Company that does not make a check the box election.

In two cases known as *Pierre v. Commr*., the Tax Court ruled that for purposes of valuing a gift subject to U.S. gift tax, a single member disregarded entity must be respected as an entity. There is no consensus among commentators regarding the effect of *Pierre v. Commr*. in the context of a foreign disregarded entity. The I.R.S. likely would choose to apply the check-the-box rules for disregarded entities literally, meaning that estate tax is due. But for those tax planners wishing to be optimistic, this case gives some comfort to argue that an Israeli company that checks the box for U.S. income tax purposes should not be ignored for estate tax purposes. How much comfort is an open question. Consequently, if risk is tolerable, but to a degree, it seems better that a second shareholder is introduced, thereby potentially strengthening the argument as mentioned above. However, the two *Pierre v. Commr*. cases discussed a single member L.L.C. and not a partnership, and also, more importantly, discussed valuation and not situs. And in post-2017 Tax Reform that changed the taxation of a sale of partnership interest by a foreign person, which is applicable also to the sale of a foreign partnership, the risk continues to be real. This change (known as the law after the *Grecian Magnesit* case) leads us to believe that the current view of the I.R.S. towards partnerships is that of an aggregate of the partners rather than a separate entity, meaning that each partner is treated as owning proportional share of the assets and income of the partnership. It seems therefore that taking this position with respect to structures that result in U.S. tax filing reporting income from a U.S. business may be riskier than in structures that do not (for example, ownership of stock portfolio).

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While an argument might exist, and in certain facts and circumstances an opinion might be obtained in support of the argument, a risk remains, and the structure does not offer the same level of assurance that a foreign corporation offers. In some circumstances, term life insurance policies may be a practical solution, if the investor is insurable.

TRUSTS

Trusts can offer estate tax protection if drafted carefully. The trust deed must limit the settlor's ability to control decisions over the trust, its income, the deployment of its assets, and the interests of beneficiaries. It must also eliminate the settlor's power to benefit from the trust. For many investors, loss of control by the settlor is a deal breaker. They are not willing to part with the assets, income, and cash flow for the trust to be an effective planning tool.

"It is often difficult for an investor based in Israel and investing in the U.S. to find the 'golden ticket' that results in little or no income and estate taxes in both places."

Even where continuing powers or enjoyment of income are not present, the types of investments that are made by the trust could cause the trust to lose its estate planning purpose if the trust looks more like a business entity and as a result is taxable as a corporation. Further, if a non-U.S. domestic trust is used, F.I.R.P.T.A. remains applicable. If a U.S. domestic trust is created but the settlor or beneficiaries are Israeli residents, Israel is likely to treat the trust as an Israeli resident. If the trust is a dual tax resident, the Treaty is not available without a competent authority determination.

Advantages

Trusts are taxed as individuals, albeit taxed at more steeply graduated rates for ordinary income. Nonetheless, the beneficial long-term capital gain rate can be utilized providing a maximum rate of 20% Federally. Additionally, trusts offer reliable protection from estate tax if structured properly.

Challenges

As mentioned above, many individuals are not ready to part with the control that is required in order to achieve estate tax protection. A trustee must be identified, and high costs of formation and maintenance may be involved.

CONCLUSION

Being compliant in more than one jurisdiction is always complex. It is often difficult for an investor based in Israel and investing in the U.S. to find the "golden ticket" that results in little or no income and estate taxes in both places. More often than not he or she can end up with far more tax than anticipated. Some structures clearly minimize excess income taxes. Others clearly minimize estate tax exposure. Perhaps the correct path depends on the age and health of the investor as the importance of certain goals change over the course of a lifetime.

DYNASTY IN THE DETAILS – U.S. ESTATE PLANNING CONSIDERATIONS FOR GLOBAL FAMILIES

Author
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Tags
Domestic Trust
Dynasty Trust
Foreign Trust
Generation Skipping Tax
Section 684
Section 679

INTRODUCTION

In the United States, creating "dynasty trusts" has become common planning tool for many estate planners. A dynasty trust is a trust that may continue for generations under applicable law. It has a myriad of benefits for strategic income, estate and gift tax planning, creditor protection and ensuring family inheritance.

All too often, a person will create a dynasty trust thinking that he or she has set up the best possible estate plan to protect the family legacy through generations. But what happens when an heir such as a child decides to move to a different country? Or the succession of trustees includes a noncitizen, nonresident of the U.S. (an "N.R.N.C. individual")? These seemingly trivial details could unintentionally cause severe tax and other planning consequences in the U.S. and abroad.[1]

This article will explore various considerations for clients, advisors and fiduciaries when creating and administering U.S. dynasty trusts – a dynasty is in the details. It should not be set up and then forgotten.

ILLUSTRATIVE FACT PATTERN

The following typical fact pattern illustrates the continual care required by a trust and estate attorney who advises on the formation or maintenance of a dynasty trust.

Daniel and Jane Clark are prospective clients who meet with a trust and estate attorney for the first time. They wish to have the new lawyer review and update their estate planning documents.

- Daniel and Jane are married, U.S. citizens, residing in New York and have two adult children, Emily and John, each of whom are U.S. citizens. Emily is married with one child, and John is married with three children.
- The Clarks provide copies of two trust agreements – the Emily Clark Family Trust and the John Clark Family Trust – created by Jane ten years previously for the benefit of each child.
- The trust agreements provide that each trust is (i) irrevocable, (ii) for the benefit of the relevant child during the beneficiary's lifetime, and (iii) is to continue in further trust for the life of such child's children, and then (iv) is to continue to future generations.

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[1] The same issues arise if a U.S. resident trustee becomes an N.R.N.C. individual. See, for example, Nina Krauthamer and Galia Antebi, "Domestic Trust – Does Yours Satisfy the Court Test," *Insights* Vol. 8 No. 5, p. 38 (2021).

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- Each Clark Family Trust has only one trustee, who is a U.S. citizen, and no other fiduciaries are named. There are no trust protectors, distribution advisors, or investment advisors.
- Jane has the power granted to her in the trust agreement to remove and replace trustees.
- The trust agreements state that the laws of the State of New York apply in all matters of construction and interpretation.

In short, aside from the absence of replacement trustees and various advisers serving certain functions, each trust is a classic dynasty trust.

The Clarks understand that the dynasty trusts are irrevocable, but they want to make a few changes based upon Jane's limited retained powers in the trust agreements. They also want to learn how these trusts will be affected by new developments within their family.

TAX DEFINITION OF A U.S. DOMESTIC TRUST

The Clark Family Trusts are solely administered in the U.S. and the terms of the trust agreements provide that the laws of the State of New York apply in all matters of construction and interpretation. The Clark Family Trusts currently appoint only U.S. persons with decision-making authority. There is no indication that the courts of a foreign country would have any jurisdiction over any matters relating to the trusts in the event a child were to move to a foreign country.

As of its formation and through the review, each trust is a U.S. domestic trust for U.S. Federal taxation purposes. This means that the ordinary rules regarding the taxation of income and gains that appear in Subparts A , B, and C of Part I of Subchapter J of the Internal Revenue Code ("Code") – apply, beginning with Code §641 and continuing to Code §664) apply. In very broad terms, a domestic trust reports distributable net income ("D.N.I."), deducts distributions to beneficiaries and amounts required to be distributed beneficiaries, and pays tax on the balance. Beneficiaries receiving distributions from D.N.I. or required to receive distributions report those amounts as if they received a *pro rata* amount of the classes of income that comprise D.N.I. In certain limited instances, a fixed amount can be distributed to a beneficiary, and the distribution is treated as a gift from the settlor. Once a U.S. domestic trust incurs U.S. tax on retained D.N.I., no further tax is imposed on the beneficiary when the accumulated income is ultimately distributed.

A trust is a "domestic" trust if it passes each of the Court Test and the Control Test.[2] Generally speaking, a trust satisfies the Court Test if a court within the U.S. can exercise primary supervision over the trust administration.[3] A trust satisfies the Control Test if one or more U.S. persons as defined in Code §7701(a)(30) control all substantial decisions of the trust.[4] Substantial decisions include, but are not limited to, the following decisions:

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[2] Code §7701(a)(30)(E); see also Treas. Reg. §301.7701-7(a)(1).

[3] Code §7701(a)(30)(E)(i).

[4] Code §7701(a)(30)(E)(ii).

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- Whether and when to distribute income or corpus
- The amount of any distributions
- The selection of a beneficiary
- Whether a receipt is allocable to income or principal
- Whether to terminate the trust
- Whether to compromise, arbitrate, or abandon claims of the trust
- Whether to sue on behalf of the trust or to defend suits against the trust
- Whether to remove, add, or replace a trustee
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, subject to certain limitations
- Investment decisions made, including the unfettered authority of a U.S. persons to terminate a foreign investment adviser[5]

A trust that fails one test or the other is a foreign trust for U.S. Federal income tax purposes even if formed under the laws of state of the U.S.[6] An unintentional foreign trust can cause adverse tax consequences for both the grantor (*i.e.*, the creator of the trust) and the beneficiaries. These include the throwback rules with respect to accumulation distributions[7] (the details of which are outside the scope of this article). Such a trust may also be subject to additional reporting requirements that carry penalties for noncompliance.[8]

For now, based on the above, the Clark Family Trusts appear to pass both the Court Test and the Control Test and would be considered U.S. domestic trusts.

ADDITIONAL FACTS

Jane advises that she is considering changing the trustee.

- The current trustee of the John Clark Family Trust is a U.S. person who is a family friend.
- There have been several disagreements with the trustee.
- Jane holds the power granted to her in the trust agreement to remove and replace trustees.
- She would like to name another family friend to serve as a replacement trustee. The individual is not a U.S. person.

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5 Treas. Reg. §301.7701-7(d)(1)(ii).

6 Code §7701(a)(31)(B). There are a few safe harbors and relief provisions to retain domestic trust status, see Treas. Reg. §301.7701-7(c), and Treas. Reg. §301.7701-7(d)(2).

7 Code §§665-668.

8 Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) and Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner).

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NEW TRUSTEES/NEW PLACE OF RESIDENCE

As noted above, carefully selecting the trustees, trust protectors, distribution advisors, investment advisors, and their successors are key considerations in satisfying the Control Test. Continually satisfying this test over the life of the trust can prove difficult, especially when administering dynasty trusts that are expected to be in existence for many years.

Dynasty trusts often give the grantor, beneficiaries, or some other person the power to remove and replace trustees. This power is typically accompanied by cautionary language under which the holder's power to remove and replace a trustee is limited, requiring the replacement trustee to be independent and not "related" or "subordinate" to the person exercising such power. It is crucial to adhere to these rules for various U.S. taxation purposes that are outside the scope of this article.[9]

In addition, it is crucial for a replacement trustee to be a U.S. person at all times relevant. If (i) the replacement trustee is not a U.S. person and (ii) the replacement trustee has the ability to control any substantial decision listed above, the trust will fail the Control Test and will be deemed to become a foreign trust.

The same logic applies when dealing with the holder of any of the following powers granted in a dynasty trust regarding fiduciaries:

- The power to designate new fiduciaries other than trustees, such as trust protectors, investment advisors, and distribution advisors.
- The power to name a successor fiduciary in the event of vacancy.
- The power to designate additional fiduciaries.
- The of a beneficiary to become a co-trustee at a certain age when the beneficiary holding that power is not a U.S. person when the power is exercised.

If the holder of any of these powers is not a U.S. person, the trust runs the risk of failing the Control Test, meaning that it would become a foreign trust. This change of status brings Code §684 into play.

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[9] A trust can be considered to be a "grantor trust" – meaning a person that settles or makes gratuitous transfers to the trust – where (i) a related or subordinate person (Code §672(c)) is trustee that controls beneficial enjoyment over the trust's assets or income (Code §674) or (ii) the grantor borrows from the trust and a related or subordinate person subservient to the grantor is the trustee (Code §675(3)). With regard to the imposition of estate tax, ordinarily property transferred during life is not subject to estate tax. But if the transferor retained rights to appoint persons who could possess the property or enjoy its income, the property is includible in the individual's taxable estate at the time of death (Code §2036). The same result exists if the transferor appoints a third person to make the decision, provided the third person can be removed by the transferor. This latter rule does not apply where the incumbent holder is an independent person and the transferor's power is limited so that only a successor independent person and be appointed. Rev. Rul. 95-58. The same result is reached under Code §2038 regarding revocable transfers, where the holder of the power is an independent person who can be replaced by the transferor only with a successor independent person.

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Code §684 provides rules that apply to transfers by U.S. persons of appreciated property to a foreign trust. Typically, the transaction must be reported on Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) and inherent gain on each appreciated asset must be recognized.

Somewhat different rules apply when a U.S. domestic trust becomes a foreign trust, sometimes referred to as a migration of the trust for tax purposes. Code §684 addresses the tax treatment of the migration in one of two ways, depending on whether the grantor of the trust is a U.S. person and whether the trust has U.S. beneficiaries.

- If there are U.S. beneficiaries and a U.S. grantor, the trust is treated as a grantor trust and the U.S. grantor becomes subject to tax on the income and gains under Code §679. Under that provision, a U.S. person who directly or indirectly transfers property to a foreign trust having one or more U.S. persons as beneficiaries is treated as the owner of the portion of the trust attributable to the transferred property.
    - If at some point in the future, the trust ceases to be treated as a grantor trust in whole or in part, the change in status causes the U.S. grantor to be treated as having transferred the underlying assets of the grantor trust to a foreign nongrantor trust. Gain must be recognized immediately before (but on the same date that) the trust is no longer treated as owned by the U.S. grantor.[10] Only gain on the assets that are no longer treated as being owned by the U.S. grantor is deemed recognized.
    - If the U.S. grantor dies, gain on all assets in the portion of the trust that is a grantor trust is recognized. Recognition is deemed to occur immediately before the grantor's death.
- If at the time of migration of the trust, the facts are such that there are no U.S. beneficiaries or no U.S. grantor, Code §679 ceases to be applicable. The general rule of Code §684 applies. The trust recognizes gain as a result of the migration for tax purposes.[11]

"Somewhat different rules apply when a U.S. domestic trust becomes a foreign trust, sometimes referred to as a migration of the trust for tax purposes."

When looking at the Clark Family Trusts, the trustee is the only person with the authority to make substantial decisions. Consequently, to keep the John Clark Family Trust a domestic trust, and to avoid triggering the application of Code §§684 and 679 to Jane, the non-U.S. family friend should not be appointed as the new trustee. Only U.S. persons should hold the power to make decisions or to hold the power to replace a foreign financial adviser. The following language should be included with regard to the trustee and the persons holding the power to make substantial decisions:

> Notwithstanding any other provision of this agreement to the contrary, for so long as each trust hereunder is a domestic trust for U.S. taxation purposes, each trustee of such trust shall be a "United States person" as defined in Section 7701(a)(30) of the Internal Revenue Code, as amended, and the trustees shall utilize the powers under this agreement to ensure that all trustees of such trust are United States persons at all times relevant.

[10] Treas. Reg. §1.684-2(e).

[11] Treas. Reg. §1.684-4(a).

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FURTHER CHANGE IN FACTS

Daniel and Jane advise the following anticipated changes of facts:

- Their daughter, Emily, is planning on moving to "Country X" where her husband is to be stationed by his employer.
- Emily, her husband, and her son look forward to a new adventure.
- While the change is not intended to be permanent, it will last for several years.

NEW TAX RESIDENCE = ADDITIONAL SET OF TAX RULES

When creating and administering dynasty trusts, it is important to know where the beneficiaries are domiciled currently and of equal importance where they may establish a new domicile. This is also important for grantors and fiduciaries of the trust. While a beneficiary may seek to find a new life in another country, the trust may not be a good travel companion.

Every country has its own laws concerning estate succession, and not all countries recognize trusts to have the same legal effect as in the U.S. For those countries that do recognize trusts, distributions from a U.S. trust can be taxed both at the level of the trust and at the level of the beneficiary. Additionally, the relocation of a beneficiary may trigger trust reporting requirements in the new country. If the beneficiary decides to expatriate, additional tax and other implications could occur both in the U.S. and in the new country.

The beneficiary and any future beneficiary should be mindful of how the move affects inheritance rules in the new location and how the move affects the family's estate plan. In principle, this is a consideration that should be addressed before a move. Often, however, family estate planning is put on the back burner.

Here are some problems that arise in practice:

- What if the beneficiary decides to renounce U.S. citizenship?
- Will the expectancy precede the renunciation of citizenship?
- What if the beneficiary is expected to become a co-trustee of the dynasty after renunciation occurs?

It is recommended that these and other expectations should be addressed before the beneficiary leaves the U.S. It is extremely important to have the dynasty trust reviewed by competent advisors in both the U.S. and the new country to determine the best strategy. In some circumstances, it may be beneficial to change the beneficiary's interest in the trust through a process known as decanting. If the relocating person is a remainderman of a dynasty trust of which he or she currently has no present interest, decanting the trust to change the person's remainder interest to an outright distribution may be an option that provides benefits in the new jurisdiction of residence.

It may be recommended to reclassify the dynasty trust to a foreign trust. A properly structured dynasty trust may contain the following language to provide such flexibility.

> The trustees may change the situs of any trust under this Agreement, and to the extent necessary or appropriate, move trust assets to a state or country other than the one in which the trust is then administered if the trustees shall determine it to be in the best interest of the trust or the beneficiaries. The trustees may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances. Notwithstanding the foregoing, the trustees shall first consult with a tax adviser prior to the change of situs of any trust hereunder in order to ensure no adverse tax consequences would result from the change of situs under Section 684 of the Internal Revenue Code, as amended, or otherwise.

FINAL CHANGES IN FACTS

As the meeting with Daniel and Jane draws to a close, Daniel directs the discussion towards his mother.

- Daniel's mother is an N.R.N.C. individual with regard to the U.S.
- She would like to provide for her grandchildren in the U.S. and their descendants.

U.S. citizens and U.S. residents for income tax purposes are taxed on their worldwide income and gains. However, the term "resident" has a somewhat different meaning for estate, gift, and generation-skipping transfer ("G.S.T.")[12] tax purposes.

For income tax purposes, the term "resident" is defined in Code §7701(b). Broadly speaking, a noncitizen individual is considered to be a resident for income tax purposes if either of two tests are met. One is the green card test, under which an individual holding permanent resident visa is considered to be a U.S. income tax resident. The other is the substantial presence test, under which an individual is considered to be a U.S. income tax resident if he or she is present in the U.S. for a targeted number of days over a three-year period.

For estate tax purposes, a noncitizen individual is considered to be a resident of the U.S. by reference to domicile. Thus, the relevant estate tax regulations[13] provide as follows:

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[12] In very broad terms, G.S.T. is a tax that is imposed when property passes from a donor or decedent to a family member that is two or more generations removed from the donor or decedent. The goal is to prevent wealthy families from saving on overall inheritance taxes by means of providing first generation heirs or recipients with a life estate or a trust interest. G.S.T. is imposed when property passes to remaindermen, heirs, or trust beneficiaries below the first generation. See Code §§2601 to 2664.

[13] Treas. Reg. §20.0-1(b)(1).

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Estates Of Citizens Or Residents. —

> Subchapter A of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a citizen or a resident of the United States at the time of his death. A "resident" decedent is a decedent who, at the time of his death, had his domicile in the United States. The term "United States", as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States. See section 7701(a)(9). A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. * * *

In comparison to most European countries, the U.S. imposes estate, gift, and G.S.T. taxes on the N.R.N.C. individual making the gift or the estate of the nonresident decedent. With the exception of U.S. citizens and residents receiving a gift or bequest from a "covered individual" – *i.e.*, an expatriate who was taxed under Code §877A[14] – the taxpayer is not the U.S. individual who receives the gift or inheritance. In addition, only U.S. situs tangible personal property[15] and U.S. real estate[16] are subject to gift tax. Thus, for example shares of stock or debt instruments are not subject to gift tax. They are, however, subject to estate tax as long as the property is situated in the U.S.

"It is important to note that the N.R.N.C. individual that establishes the dynasty trust may be subject to applicable tax rules and reporting requirements in the home country."

For an N.R.N.C. individual who wishes to provide a gift or bequest to a U.S. beneficiary, a U.S. domestic dynasty trust can be an attractive option. Typically, a dynasty trust is established by an N.R.N.C. individual for the benefit of a U.S. individual. It can be structured as an irrevocable "nongrantor" trust. This means that the trust is considered a separate U.S. taxpayer for U.S. Federal income tax purposes, taxed on worldwide income accumulated and realized in the trust. The property gifted to the dynasty trust consists of property that does not attract gift tax for an N.R.N.C. individual. In addition, if established during the lifetime of the N.R.N.C. individual with assets that do not attract gift tax, G.S.T. is not imposed as succeeding generations become beneficiaries.[17]

It is important to note that the N.R.N.C. individual that establishes the dynasty trust may be subject to applicable tax rules and reporting requirements in the home country. Additionally, the recipient dynasty trust (or any beneficiary receiving a gift from a non-U.S. person) has reporting obligations in the U.S. which are separate from that of the grantor. For example, Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) must be filed for each year in which the dynasty trust receives a gratuitous transfer from the N.R.N.C. individual

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[14] Code §2801.

[15] Code §2501(a)(2) eliminates U.S. gift tax on items of U.S. situs intangible property.

[16] Code §2511(a).

[17] Code §2663(2); Treas. Reg. §26.2663-2(b).

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CONCLUSION

Several takeaways regarding cross border trust and estate planning:

- Always be mindful of where the grantor, fiduciaries, and beneficiaries reside currently, and if possible to project, where they may reside in the future.
- Make sure current and future beneficiaries are aware of their interests in dynasty trusts. Even if family relations suggest otherwise, some degree of communication is helpful.
- Do pre-immigration planning – consult with U.S. and foreign advisors as to the treatment of the dynasty trust before immigrating.
- N.R.N.C. individuals should consider gifting of intangible personal property to U.S. persons rather than tangible. Investment grade bonds of U.S. issuers are preferred; jewelry kept in a vault in the U.S. is problematic.
- Check in with advisors during any major life event: birth, marriage, divorce, death, retirement, impending relocation. These are the times to review the planning currently in place and discuss ways to remain in compliance.

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HOORAY FOR NEW MATH: IS IT REALLY A SIMPLIFIED TRANSFER PRICING APPROACH FOR 2025?

Author
Michael Peggs

Tags
B.M.A.D.
L.R.D.
Pillar One
S.S.A.
Tangible Property
Transfer Pricing

You can't take three from two
Two is less than three
So you look at the four in the tens place
Now that's really four tens
So you make it three tens
Regroup, and you change a ten to ten ones
And you add them to the two and get twelve
And you take away three, that's nine
Is that clear?

Lehrer, Tom. "New Math." *That Was the Year That Was*, 1965

As promised before the end of 2024, Treasury and the I.R.S. outlined their approach to the codification of Amount B, a component of the O.E.C.D. Pillar One approach[1] ("O.E.C.D. guidance") relevant to controlled distribution transactions of tangible property, in *Notice 2025-04* on December 18, 2024.[2] Taxpayers can elect to use the streamlined, simplified approach ("S.S.A.") for corporate tax years beginning on or after January 1, 2025. The I.R.S. will consider the S.S.A. to be the best method under the Treas. Reg. §1.482-1(c) best method rule if a valid election to apply the S.S.A. has been made. *Notice 2025-04* points out that simplifying measures are not new to regulations issued under Code §482, citing the familiar applicable federal rate ("A.F.R.") available for use in setting an arm's length rate of interest and the services cost method ("S.C.M.") that can be used to price certain types of controlled services transactions.

Notice 2025-04 is a response to the broadening adoption of Amount B by U.S. treaty partners as a near-term political consolation prize to the wider Pillar One transfer pricing reform ambitions of the O.E.C.D. membership and its somewhat skeptical developing country partners. It is not likely that the two-Pillar approach, of which Pillar One is part one of two parts, will become law during the second Trump Administration. From the U.S. perspective, Amount B is a limited-scope practical simplification measure and a way of managing Competent Authority disputes involving relatively straightforward controlled inventory transactions.

1 O.E.C.D. (2024), Pillar One - Amount B: Inclusive Framework on BEPS, O.E.C.D./G20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

2 "NOTICE 2025-04: Application of the Simplified and Streamlined Approach under Section 482." Internal Revenue Service. Accessed January 30, 2025.

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FROM THE RUINS OF PILLAR ONE EMERGES…

Along with Pillar Two, a series of rules designed to implement a global minimum corporate tax, Pillar One began as a 2019 second-phase of the O.E.C.D./G20 B.E.P.S. transfer pricing initiative to multilaterally change the rules that allocate profit to market jurisdictions in the digital economy and reallocate the right to tax away from countries whose multinationals own valuable intangible property. The Pillar One rules featured three amounts: A, B, and C (C was dropped along the way), that aimed to identify and re-allocate profit of in-scope multinational corporate taxpayers. Amount A uses allocation principles other than the arm's length principle that underlies Code §482, while Amount B applies the arm's length principle in a mechanical way to determine the return to certain qualifying "baseline distributors."

No agreement was reached on Amount A by the O.E.C.D. deadline of June 30, 2024, but work on the relatively less controversial Amount B continued as a substantial guidance report was previously incorporated into the O.E.C.D. Transfer Pricing Guidelines on February 19, 2024. The O.E.C.D. published two supplementary statements to the Amount B guidance on June 17, 2024, and a fact sheet and spreadsheet template to assist with the implementation of Amount B on December 19, 2024. The O.E.C.D. Amount B guidance and the supplementary statements will become part of the proposed S.S.A. regulations by reference.

THE B.M.A.D. TO END ALL L.R.D.'S

To be eligible to apply the S.S.A. as a specified method under the Code §482 regulations, the electing taxpayer must carry on a controlled transaction that is both a qualifying transaction and an in-scope transaction. The S.S.A. defines the terms "distributor," "wholesale distribution," "retail distribution," "core distribution functions," "non-distribution activities," and "baseline distribution." Core distribution functions are those functions typically performed by baseline distributors. Non-distribution activities are activities that are other than wholesale distribution activities, or retail distribution activities accounting for revenue in excess of 20% of entity three-year weighted average net revenues. Examples of non-distribution activities provided in the O.E.C.D. guidance are non-incidental manufacturing, research and development, and procurement or financing.

With these definitions in mind, and following the completion of a functional analysis for the purpose of establishing an understanding of the transaction characteristics, a qualifying transaction is determined as follows:

- A transaction that by reference to the O.E.C.D. guidance involves a distributor that can be selected as the tested party when using a one-sided transfer pricing method. This step accomplishes the qualitative appraisal of the contributions of risk and valuable intangible property to the profitability of the tested party, and the evaluation of the availability of reliable data to use in making these determinations and in calculating a tested party return.
- Other than a transaction involving "the distribution of non-tangible goods, services or the marketing, trading, or distribution of commodities."

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- Other than a transaction involving non-distribution activities unless the non-distribution activities can be reliably segmented to obtain reliable financial data directly relevant to the qualifying baseline marketing and distribution activity.
- An in-scope transaction. An in-scope transaction defined as follows:
  - In the case of a U.S. distributor, a transaction carried on between either
    - a related supplier domiciled in a country that has not adopted the S.S.A.[3] and a U.S. distributor that reports an operating expense to sales ratio between 3% and 30%, or
    - a related supplier domiciled in a country that has adopted the S.S.A. and a U.S. distributor that reports an operating expense to sales ratio between 3% and 30%.
  - In the case of a non-U.S. distributor, a transaction carried on between a U.S. related supplier and non-U.S. distributor domiciled in a country that has adopted the S.S.A. that reports an operating expense to sales ratio between 3% and an amount between 20% and 30%.

Consideration of the presence or absence of a controlled tangible property transaction that may qualify to apply the S.S.A. is governed by existing law, as is the economic substance of the activity relevant to the controlled transaction.

Faithful readers will know that *Insights* prides itself on an occasional flash of prescience. You may have heard of a limited-Scope, low-risk or limited-risk distributor or "L.R.D.," an undefined creature of transfer pricing slang that is both well-known and practically problematic. A tax administration's idea of an L.R.D. may not coincide with a taxpayer's understanding of the true taxable meaning of this item of T.P. slang. Enter the proposed "B.M.A.D." or baseline marketing and distribution entity in regulations issued under Code §482 as a defined term by direct reference from O.E.C.D. Guidance.[4] R.I.P. L.R.D.

Finally, note the 'M' in B.M.A.D. is silent in the O.E.C.D. "baseline distribution" terminology. Marketing activities, frequently controversial given their role in creating and popularizing intangible property, are referenced in the O.E.C.D. guidelines definition of "core distribution functions" as "implementing promotional advertising or marketing activities." Differentiating between "good M" and "bad M" for the purpose of identifying a qualifying transaction is accomplished first by the qualitative assessment of functional analysis, and second by the quantitative measure of marketing and advertising expenditure as a component of operating expense intensity.

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[3] There are seven footnotes beginning "Note by India:" to the Introduction section of the O.E.C.D. guidance that are all critical of the validity of aspects of Amount B.

[4] Michael Peggs and Michael Bennett, "Entering A New Dimension – O.E.C.D. Transfer Pricing Guidance As Hard Tax Law," *Insights* Vol. 10, No. 6, p.17 (2023).

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NOW FOR THE EASY PART

Determining whether a transaction is both qualifying and in-scope at this stage might seem neither simple nor streamlined. The remaining steps, however, provide some insight into the motivation of the O.E.C.D. guidance and the notice of proposed regulations under Code §482.

In conventional transfer pricing analysis, the next step would be a search for comparable data, method selection, best method analysis, comparability analysis, and the quantitative application of the selected method. Some inference can then be made about the arm's length return of a distributor in a controlled transaction. The S.S.A. allows taxpayers to opt out of this next analytical step that some taxpayers find to be complicated and costly in terms of compliance.

"Perhaps the most exciting innovation of Amount B is its grant of exemption to properly electing taxpayers and their transfer pricing analysts from the requirement to produce tables, schedules, figures and other such non-streamlined graphics."

The I.R.S. and other tax administrations may also skip this step, though there is some variation across countries in the way in which a tax administration can apply Amount B without a taxpayer election. The ability of the I.R.S. to apply the S.S.A. without a taxpayer election will be considered during the drafting of the proposed regulations and through ongoing public commentary and response. Examination disputes and double tax controversy over distribution transactions are the simplification targets of the S.S.A. and of similar legislation or regulations issued by foreign tax administrations.

Perhaps the most exciting innovation of Amount B is its grant of exemption to properly electing taxpayers and their transfer pricing analysts from the requirement to produce tables, schedules, figures and other such non-streamlined graphics. The S.S.A. references three tables in Section 5 of the O.E.C.D. guidance, and those three tables and their associated eight simple steps along with the choice of one of three possible industry groupings result in a nouveau-arm's length operating margin return for the qualifying, in-scope B.M.A.D. transaction activity. The O.E.C.D. will update the tables and other key data inputs every five years.

THE S.S.A. RECIPE

The how-to of the S.S.A. is outlined in Section 5 of the O.E.C.D. Amount B report. First, an Industry Grouping is chosen from the three lists in the Introduction of the O.E.C.D. guidance. A list of accounting data ingredients in set out as item (v) in the documentation requirements list for the S.S.A. in *Notice 2025-04*.

Using the appropriate operating assets (defined as fixed assets and working capital with a 90-day limit to accounts payable) to net sales ratio (O.A.S. in the table below) and operating expenses to net sales ratios (O.E.S. in the table below), a return on sales percentage (E.B.I.T. as a percentage of net sales) can be identified from the corresponding row and column. Where more than 20% of total B.M.A.D. revenue is derived from more than one industry grouping, a sales-weighted average return on sales should be calculated.

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Table 5.1. Pricing Matrix (Return on Sales %) Derived from the Global Dataset[5]

Factor Intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] High O.A.S. / any O.E.S. >45% / any level	3.50%	5.00%	5.50%
[B] Med/high O.A.S. / any O.E.S. 30% - 44.99% / any level	3.00%	3.75%	4.50%
[C] Med Low O.A.S. / any O.E.S. 15%-29.99% / any level	2.50%	3.00%	4.50%
[D] Low O.A.S. / non-low O.E.S. <15% / 10% or higher	1.75%	2.00%	3.00%
[E] Low O.A.S. / low O.E.S. <15% O.A.S. / <10% O.E.S.	1.50%	1.75%	2.25%

Source: O.E.C.D. Amount B Report, February 2024

An acceptable range of return on sales for the B.M.A.D. lies between the calculated return on sales plus and minus 0.5%.

Next, test your baking with the operating expense cross-check. This step adjusts E.B.I.T. until the B.M.A.D.'s E.B.I.T./operating expense ratio corresponding with its operating asset to sales ratio falls within the minimum ("collar") to maximum ("cap") interval in the table below. The purpose of this adjustment is to truncate the profitability of B.M.A.D.'s with lower than normal operating expense intensity and to increase the return to B.M.A.D.'s with higher than normal operating expense intensity. Readers may recognize this profit level indicator as an expense denominated profit level indicator commonly used in the application of the comparable profits method ("C.P.M.") to services transaction pricing.

Table 5.2. Operating Expense Cap-and-Collar Range[6]

Operating Expense Cap-and-Collar Range			
Factor Intensity	**Default Cap Rates**	**Alternative Cap Rates for qualifying jursdictions**	**Collar Rate**
High O.A.S. (A)	70%	80%	10%
Medium O.A.S. (B+C)	60%	70%	
Low O.A.S. (D+E)	40%	45%	

Source: O.E.C.D. Amount B Report, February 2024

[5] O.E.C.D. (2024), Pillar One - Amount B: Inclusive Framework on BEPS, O.E.C.D./G20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris, p. 27.

[6] *Id.*, p. 29.

The last adjustment is a geographic risk `adjustment and depends on the domicile of the B.M.A.D. in a "qualifying jurisdiction," as defined by the O.E.C.D. in its June 17, 2024 statement.[7] Mexico, Brazil, India, and China are among the countries presently classified as qualifying jurisdictions. The net risk adjustment factor by country credit rating as of the beginning of the relevant fiscal year from the table below is multiplied by the operating assets to sales ratio of the B.M.A.D. and added to the adjusted return on sales to obtain the final result.

Table 5.3. Net Risk Adjustment Percentage to be Applied to the O.A.S. of a Tested Party in Qualifying Jurisdictions[8]

Sovereign Credit Rating Category		Net Risk Adjustment %
Investment Grade	BBB+	0.0%
	BBB	0.0%
	BBB-	0.3%
Non-Investment Grade	BB+	0.7%
	BB	1.2%
	BB-	1.8%
	B+	2.8%
	B	3.8%
	B-	4.9%
	CCC+	5.9%
	CCC	7.5%
	CCC- (or lower)	8.6%

Source: O.E.C.D. Amount B Report, February 2024

For those who don't like to bake from scratch, the O.E.C.D. has released a spreadsheet used to calculate the adjusted return on sales required under the S.S.A.[9] It comes with a disclaimer of liability of the O.E.C.D. to users of the calculation template. A similar disclaimer is expected in the proposed regulations, as the spreadsheet was issued a day after *Notice 2025-04*. Any application of the S.S.A. not in accordance with the regulations and the O.E.C.D. guidance will be treated as an unspecified method and evaluated under the Code §482 regulations.

Helpfully, the S.S.A. anticipates the position of both the supplier and distributor tax jurisdictions in the transfer pricing position of the B.M.A.D. Transfer pricing` positions can often be complicated by different treatment of the same transaction by the relevant tax administrations, causing taxpayers and their advisors to make educated guesses and hedge their positions often by documenting asymmetrically.

7 "Statement on the Definitions of Qualifying Jurisdiction within the Meaning of Section 5.2 and Section 5.3 of the Simplified and Streamlined Approach." OECD. Accessed January 30, 2025.

8 *Id.*, p, 31.

9 "Pillar One – Amount B | OECD." OECD. Accessed January 30, 2025.

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For anyone who has ever sat through an argument with two or more transfer pricing economists about distribution comparables, the S.S.A. promise of simplification will be meaningful relief.

Whether the S.S.A. remains accessible solely through taxpayer election is a point to watch for in the proposed regulations, and could change the controversy landscape looking ahead. We note that while the narrowed scope for disagreement over the income of a controlled distributor is likely to result in smaller dollar value income adjustments under the S.S.A., this only implies there will be an equal number of lower value double tax issues. Given the time to resolution and cost of engaging in a mutual agreement procedure to eliminate the risk of double taxation, it remains to be seen whether the S.S.A. and its Amount B foreign equivalents will reduce the total global deadweight loss from double tax caused by tax authority controversy over B.M.A.D. returns.

DON’T FORGET TO SHOW YOUR WORK

Specific documentation requirements apply as a result of the election to use the S.S.A. These requirements specifically replace those found in Treas. Reg. §1.6662-6(d)(2)(iii)(B) and (C). Of note is the requirement to include a copy of the intercompany agreement between the related supplier and the B.M.A.D. that has elected to use the S.S.A. This assumes the existence of an intercompany agreement, now in an official way.

“The S.S.A. should not signal to companies that less documentation supporting the existence of the transaction in its actual form is acceptable.”

The S.S.A. should not signal to companies that less documentation supporting the existence of the transaction in its actual form is acceptable. This is something that we find companies and their advisors often overlook or ignore in favor of treating transfer pricing as a backward-looking compliance exercise for transactions of settled form and terms. *Notice 2025-04* notes the S.S.A. will not be regarded as the best method if either the taxpayer or the tax administration demonstrates that the comparable uncontrolled price method can be applied more reliably and is instead the best method. Companies must therefore not shortcut transfer pricing method selection and assessment of reliability if an election is made to apply the S.S.A.

The documentation requirement under the S.S.A. and the O.E.C.D. Amount B documentation requirement are similar but not identical, and taxpayers managing global documentation standards should note this point of nuance. As with other transfer pricing documentation, the requirement is that S.S.A. documentation should be present at the time of filing the corporate tax return and provided to the I.R.S. within 30 days following the date of an I.D.R.

Should they appear in the next four years, we expect the proposed regulations to address the question of the application of the S.S.A. across taxation years and across qualifying and in-scope transactions following the receipt of comments. The O.E.C.D. appears to be looking at the same design features, which will help minimize controversy at both the examination and Competent Authority levels.

CONCLUSION AND POSTSCRIPT

Whether transfer pricing analysis and documentation is expected to become simpler for taxpayers as a result of the proposed S.S.A. depends on a taxpayer’s facts and circumstances. Taxpayers considering a 2025 election should carefully weigh the

benefits and costs of applying the S.S.A., bearing in mind the state of the law and guidance in the foreign jurisdiction that either supplies the U.S. B.M.A.D. or where the B.M.A.D. purchasing inventory from a U.S. supplier is resident.

An O.E.C.D. January 16, 2025, Pillar One update[10] indicates a remaining lack of consensus on Amount A, ongoing work on finer points of policy design for Amount B, ongoing negotiations concerning the inappropriate outcome of Amount B in the view of certain dissenting jurisdictions, and ongoing efforts to complete the drafting of a multilateral convention to implement Amount A and "a framework for Amount B." Participating countries may view the Pillar One effort as inclusive, but only time will tell whether consensus can emerge. Until then:

> *Hooray for new math*
> *New-hoo-hoo math!*
> *It won't do you a bit of good to review math*
> *It's so simple*
> *So very simple*
> *That only a child can do it!*
>
> Lehrer, Tom. "New Math," *That Was the Year That Was*, 1965

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[10] "Pillar One Update from the Co-Chairs of the Inclusive Framework on BEPS," OECD. Accessed January 30, 2025.

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READING TEA LEAVES – WHAT MAY BE IN STORE FOR TAX LEGISLATION

Author
Nina Krauthamer

Tags
Tariffs
Tax Legislation
T.C.J.A.
State and Local Tax

President Trump made several tax proposals in the course of his winning campaign for the White House. Here is a list of those proposals and the likely response of Democrats in Congress followed by a general analysis of various positions. Note that the Republicans hold small majorities in both the Senate and the House of Representatives.

PROPOSALS AND LIKELY RESPONSES

1. **President Trump proposes to make permanent the individual tax cuts contained in the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.").**

   Democrats likely respond that this benefit, while applying to all taxpayers, will benefit those with high incomes, potentially increasing the federal deficit.

2. **President Trump proposes lowering the corporate tax rate to 15% - 20%.**

   Democrats respond that this will benefit large corporations and wealthy shareholders.

3. **President Trump proposes higher tariffs.**

   Democrats respond that while these revenues will offset revenue loss from lower income taxes, it may increase the price of some consumer goods.

4. **President Trump proposes exempting overtime pay and tips from federal tax.**

   Democrats respond that this may provide relief for some workers but may cause tax revenue loss.

5. **President Trump proposes ending taxes on Social Security benefits.**

   Democrats respond that this will benefit many senior citizens but could have negative effects on the solvency of the Social Security system, possibly resulting in a cut to future benefits.

6. **President Trump proposes making T.C.J.A. estate tax cuts permanent.**

   Democrats respond that this will benefit wealthy individuals and families.

7. **President Trump proposes raising the state and local tax ("S.A.L.T.") deduction cap.**

   Democrats respond that the S.A.L.T. deduction should be unlimited.

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8. **President Trump proposes eliminating clean energy tax incentives.**

Democrats respond that this would eliminate many popular tax incentives, with possible higher consumer costs.

COMMENTARY

Americans for Prosperity ("AFP"), a conservative political action committee backed by Charles Koch, announced that it is launching a $20 million ad blitz in support of President Trump's proposal to extend the "T.C.J.A."

AFP said in a statement released Monday, January 20, 2025. that it will "protect prosperity and renew" President Trump's $4.5 trillion tax initiative. It is "urging Americans to unite in telling Washington that now is not the time for higher taxes."[1]

These tax incentives come with a heavy price tax. Former U.S. Treasury Secretary Janet Yellen stated that the extension of the T.C.J.A. 2017 tax cuts set to expire in 2026 will add to unsustainable deficits. The Tax Foundation (whose estimates of the impact on the deficit is the most optimistic of those institutes making such a prediction) has reported that:

> In all, making the TCJA permanent would boost long-run GDP by 1.1 percent and employment by 913,000 full-time equivalent jobs, while reducing revenue by $4.0 trillion on a conventional basis. Though TCJA permanence would be pro-growth, it would still result in significant revenue losses on a dynamic basis, amounting to $3.5 trillion over the 10-year budget window. In the long run, TCJA permanence would increase the debt-to-GDP ratio by 25.5 percentage points conventionally and 19.0 percentage points dynamically.[2]

A number of conservatives want their proposals to reduce or at least not add to the deficit. President Trump's tax package is likely to add to the deficit, and it will be difficult to offset its costs without losing Republican votes.

State and local taxes are of particular concern to Republican representatives in Democrat states. In a meeting with more than a dozen House Republicans from New York, New Jersy and California, President Trump asked the Republicans to produce a plan for increasing the S.A.L.T. deduction. Republicans are divided on the issue. Some would raise or abolish the limit, others would increase the limit to account for inflation, and yet others would potentially increase the limitation for married couples. There seems to be a consensus among Republicans that some cap will be necessary. Other Republicans, leery of providing a tax benefit for wealthy Democrats would prefer no changes at all. Interestingly, some Republican lawmakers known as "the Freedom Caucus" have explored limiting the ability of businesses to deduct State and local taxes to raise revenue for other cuts. They would trade the S.A.L.T. deduction for higher corporate rates.

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[1] Scully, Rachel. "Koch-Backed Group Unveils $20M Campaign Highlighting Trump Tax Cuts." *The Hill*, January 13, 2025.

[2] "Options for Navigating the 2025 Tax Cuts and Jobs Act Expirations." *Tax Foundation*, December 4, 2024.

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Answers to these questions will be forthcoming in the next few months. House Speaker Mike Johnson (R-La.) is now pushing with an aggressive timetable to get a full floor vote by April on a sweeping border, energy, and tax package.[3] Senate Finance Committee Chair Mike Crapo (R-Idaho), the lead tax negotiator in the Senate, acknowledged negotiators are currently working through possible S.A.L.T. trade-offs.

PATH FORWARD

It is important to remain flexible until actual tax proposals have been suggested and enacted. *The Kiplinger Report*[4] notes several potential tax traps for individuals attempting to make tax planning decisions in advance of legislative activity:

- Assuming tax cuts are coming or will be permanent.
- Overlooking the impact of tariffs.
- Delaying taking advantage of clean energy tax credits.
- Counting on a S.A.L.T. cap change to help one's tax bill.
- Neglecting retirement and estate planning.

"It is important to remain flexible until actual tax proposals have been suggested and enacted."

[3] Guggenheim, Benjamin. "Freedom Caucus Floats Corporate Tax Boost in Exchange for Easing State, Local Deduction Cap." *Politico*, January 15, 2025.

[4] Taylor, Kelley R. "The Fine Print: What Trump Isn't Telling You about His 2025 Tax Plans." *The Kiplinger Report*, January 16, 2025.

ANOTHER TAXPAYER ALLOWED TREATY-BASED FOREIGN TAX CREDIT AGAINST N.I.I.T.

Author
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Tags
Foreign Tax Credit
Net Investment Income Tax
Tax Treaty

The application of the foreign tax credit to the net investment income tax ("N.I.I.T.") has been a recurring battle in courtrooms in recent years. In the most recent installment, the taxpayer in *Bruyea v. U.S.*[1] prevailed in claiming a foreign tax credit under the Canada-U.S. income tax treaty.

BACKGROUND

N.I.I.T. and the Foreign Tax Credit

The N.I.I.T. is a 3.8% tax on certain items of passive income that is levied on U.S. individuals whose gross income is above certain thresholds. Passive income that is subject to N.I.I.T. includes dividends, interest, rents, royalties, and capital gains.

In the international context, N.I.I.T. has drawn attention because of the potential for double taxation. A U.S. individual residing in another country could owe N.I.I.T. to the U.S. by virtue of his or her citizenship and tax to the foreign country by virtue of his or her residence. The U.S., like most countries, offers a foreign tax credit that can be used to offset U.S. income tax by the amount of foreign tax, thereby alleviating double taxation in many cases.

Statutory organization means that the N.I.I.T., unlike regular U.S. income tax, is not offsetable by the foreign tax credit under U.S. law. This is because the Code provides that the foreign tax credit is only usable against "the tax imposed by this chapter."[2] The foreign tax credit and regular income tax are both located in Chapter 1 of the Code. The N.I.I.T., on the other hand, is located in Chapter 2A, a chapter created solely for the N.I.I.T.

The N.I.I.T. regulations confirm this result:

> Amounts that may be credited against only the tax imposed by chapter 1 of the Code may not be credited against the section 1411 tax [the N.I.I.T.] imposed by chapter 2A of the Code unless specifically provided in the Code. For example, the foreign income, war profits, and excess profits taxes that are allowed as a foreign tax credit by section 27(a), section 642(a), and section 901, respectively, are not allowed as a credit against the section 1411 tax.[3]

Because domestic law does not provide relief, taxpayers have sought other avenues to avoid double taxation. Some commentators have argued that Social Security

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1. No. 23-766T
2. Code §901(a).
3. Treas. Reg. §1411-1(e).

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Totalization Agreements allow an exemption from N.I.I.T. for U.S. individuals residing in certain foreign countries. A more common approach has been for taxpayers to invoke income tax treaties to claim foreign tax credits. Income tax treaties between the U.S. and other countries often provide relief from double taxation by requiring the treaty countries to offer foreign tax credits to residents of treaty countries.

Earlier Cases

Previously, the Tax Court in *Toulouse* disallowed the foreign tax credit under the U.S.'s tax treaties with France and Italy.[4] The court found that the treaty provisions that the taxpayer relied on required U.S. domestic law to allow for a foreign tax credit to be allowed. For example, the taxpayer cited Article 24(2)(a) of the French tax treaty, which allows a foreign tax credit to U.S. taxpayers for French income tax. But the court observed that the credit's allowance was "[i]n accordance with the provisions and subject to the limitations of the law of the United States[.]" This language is found in most tax treaties with the U.S. and is also contained in the Italian treaty. The court interpreted this clause to mean that, for a foreign tax credit to be allowed, the credit must be authorized by domestic law. And domestic law clearly does not allow for the foreign tax credit to be applied against N.I.I.T. The court concluded as follows:

> [F]or petitioner to prevail on the basis of the provisions she cites, the Code must provide the credit if one exists * * * There is no provision for any credits against the section 1411 tax [the N.I.I.T.].

Similar reasoning saw a taxpayer, relying on the South Korea-U.S. tax treaty, defeated in *Kim*.[5]

In *Christensen*,[6] the taxpayers, also relying on the French treaty, prevailed by citing a different provision of the French treaty: Article 24(2)(b), which is specific to individuals who are U.S. citizens residing in France. The *Toulouse* taxpayer had not cited Article 24(2)(b), and the court there never discussed it. The Court of Federal Claims found that the second treaty provision did not rely on domestic law to be operative and independently authorized the foreign tax credit. This was because this subparagraph did not subject the foreign tax credit to the limitations of U.S. law. But the court seemed to agree with the *Toulouse* court's interpretation of Article 24(2)(a).

BRUYEA: A NEW APPROACH

Paul Bruyea is an American citizen residing in Canada. In 2015, Mr. Bruyea paid both Canadian income tax and N.I.I.T. on gains from the sale of real estate. Although he did not initially claim a foreign tax credit, he did so on filing a claim for a refund. He based his claim on Article XXIV (Elimination of Double Taxation) of the treaty with Canada. Paragraph 1 of that article provides, in relevant part:

> * * * In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United

[4] 157 T.C. No. 4 (2021).

[5] 664 F. Supp. 3d 1062 (2023).

[6] 664 F. Supp. 3d 1062 (2023).

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States shall allow to a citizen or resident of the United States…as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada * * *

For U.S. citizens resident in Canada, paragraph 4(b) further provides as follows:

> [F]or the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada * * *

"United States tax" is defined elsewhere in the treaty as "taxes on income and on capital…irrespective of the manner in which they are levied," including the following:[7]

- The Federal income taxes imposed by the Internal Revenue Code of 1986
- Any taxes identical or substantially similar to those taxes to which the Convention applies which are imposed after March 17, 1995 in addition to, or in place of, the taxes to which the treaty applies

It appears that the N.I.I.T., although enacted in 2010 and thus after the treaty came into force and effect, is covered by this definition. The court's starting point was that the treaty allowed for a credit against N.I.I.T.

The government conceded that N.I.I.T. fits the definition but argued that a foreign tax credit was nonetheless impermissible. It brought two main arguments. First, under the "last-in-time" rule, the government argued that the manner in which Congress enacted the N.I.I.T. signaled its intent for the tax to not be offsetable by a treaty-based credit.

Under the last-in-time rule, in the context of treaties, a treaty provision is given effect unless a later-enacted domestic law directly contradicts the treaty provision.[8] But for the rule to come into play, a conflict must exist. The court found that the government had not shown a conflict existed. The government's main argument was that by placing N.I.I.T. in its own chapter of the Code, separate from regular income tax, Congress indicated it did not want a treaty-based credit to be usable against N.I.I.T. The court disagreed with the government's interpretation. It did not find evidence of such an intent.

The government faced further difficulty when the court cited further interpretive principles:

> Where a treaty and a statute "relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either."[9]

Based on this premise, the court raised the burden on the government with the assumption that later laws were not intended to repeal a treaty.[10] The court asked

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[7] Canada-U.S. Income and Capital Tax Treaty Art. III(1)(d) and Art. II(2)(b) and (3).

[8] This rule is codified under Code §7852(d).

[9] Citing *Kappus v. Commr.*, 337 F.3d 1053 (2003).

[10] *Id.*

the government to show "crystal clear" language showing an intent to abrogate the treaty, which the government failed to do.

The government's second argument was familiar from the *Toulouse* case. If the foreign tax credit was "[i]n accordance with the provisions and subject to the limitations of the law of the United States," then no foreign tax credit could be claimed unless authorized by U.S. domestic law. Notably, the government applied this limitation not only to Paragraph 1 but also to Paragraph 4.

Here, the court found the government's argument inconsistent. In spite of the government's blanket application of Paragraph 1's limitation, the government conceded that there were other provisions of Article XXIV that conflicted with U.S. law. For example, Paragraphs 3 and 6 contain sourcing rules that could yield different results than under sourcing rules in the Code. When asked to reconcile these positions, the government argued that the other provisions were more specific in their intent to contradict domestic law. The court was not convinced.

At the outset of its opinion, the court observed that treaty interpretation was somewhat unique because "courts are encouraged to consider a treaty's purpose, as well as extrinsic evidence of the intent of the parties to the treaty." Here, the court found that the purpose of Article 24 was to eliminate double taxation. It found no conflict between this principle and the later enactment of N.I.I.T.

Extrinsic Evidence

The court then concluded that even if all of Article XXIV were subject to the limitations of U.S. law, it would still not preclude a credit for the taxpayer. The court cited the Technical Explanation to the treaty and found that the limitations of U.S. law applied for a much more specific purpose:

> The direct and deemed-paid credits allowed by paragraph 1 are subject to the limitations of the Code as they may be amended 28 from time to time without changing the general principle of paragraph 1. Thus, as is generally the case under U.S. income tax conventions, provisions such as Code sections 901(c), 904, 905, 907, 908, and 911 apply for purposes of computing the allowable credit under paragraph 1. In addition, the United States is not required to maintain the overall limitation currently provided by U.S. law. [11]

Therefore, the limitations of U.S. law applied for the much narrower and mechanical purpose of calculating the amount of the credit.

Other language from the Technical Explanation bolstered the taxpayer's case:

> Paragraph 1 provides a credit for these specified taxes whether or not they qualify as creditable under Code section 901 or 903.

This showed that even Paragraph 1, the only paragraph of Article XXIV that is unambiguously subject to the limitations of U.S. law, could provide relief not provided for in the Code. The court found that allowing for the credit was consistent with the principal purpose of the treaty, which was to reduce or eliminate double taxation.[12]

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[11] Emphasis added by the court.

[12] Citing the Senate report.

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It was also consistent with another treaty-interpretation principle: if a treaty provision yields two reasonable interpretations, the interpretation offering more rights is to be preferred.[13]

CONCLUSION

The taxpayer prevailed again in the Court of Federal Claims, but the taxpayer's route to victory took a very different one than in *Christensen*. *Christensen* seemed to accept the *Toulouse* argument that foreign tax credits that are provided subject to U.S. law cannot provide relief not already provided for by U.S. law. The *Christensen* taxpayers won because they found a credit not subject to U.S. law.

The *Bruyea* court, relying much more than the *Toulouse* court on outside evidence, found that being subject to the limitations of U.S. law is a much narrower restriction than what the *Toulouse* court found. A credit provided subject to U.S. law does not have to conform exactly to domestic law.

It is unclear how permanent this relief will be. *Bruyea* clearly contradicts *Toulouse*. There is a good chance that the government, which has already appealed *Christensen*, will appeal *Bruyea*. That may lead to an appeals court resolving the conflict between *Toulouse* and *Bruyea*, or it could lead to a circuit split. For now, the picture remains uncertain.

"There is a good chance that the government, which has already appealed Christensen, will appeal Bruyea."

[13] Citing *U.S. v. Stuart*, 489 U.S. 353 (1989).

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CORPORATE MATTERS: ENDING A BUSINESS RELATIONSHIP – A TIME CONSUMING AND DRAWN-OUT PROCESS

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Buy-Sell Agreement
Dissolution of L.L.C.
Partner Dispute

INTRODUCTION

Often the realities of a business arrangement can be quite different than a plan conceived between optimistic partners. Market conditions can change, and commitments made can become difficult to deliver, sometimes through no lack of trying.

As business attorneys, we have seen situations where one partner brings technical and production know-how and another brings the promise of market introductions and sales contacts. If the contacts don't pan out and the product essentially sells itself, one partner may decide that it is better to go it alone.

This is just one factual scenario that may lead a joint venture partner to decide to end a partnership. Others include changes in personal circumstances and irreconcilable differences leading to a deadlock. The question we are then asked is "what is the best way to exit the partnership?"

FOUNDING DOCUMENTS

The first step in advising a client in this predicament is to review and understand the governance provisions of the founding documents.

Often, business partnerships like the one described above are in the form of a limited liability company. The operating agreement of a limited liability company covers the rights and obligations of the parties and sets forth governance and procedural requirements of the company. Before any other steps are taken, the operating agreement should be reviewed and a clear understanding gained as to the provisions relating to member withdrawal, transfer of ownership interests, and dispute resolution.

The thought of a breakup is not usually in the forefront of the partners' minds when these documents are prepared, and these types of provisions are often pretty standard. Care should be taken when drafting an operating agreement to include provisions that are helpful to the members should the need arise. More often than not we see agreements providing for no withdrawal or transfer of a member's interest or only allowing withdrawal or transfer with the consent of the other member. In a 50/50 partnership, those types of provisions are not very helpful when a dispute arises. Obtaining the consent of the other partner may not be realistic.

If the L.L.C. does not have an operating agreement or the dissolution provisions are not helpful, Delaware law provides dissolution procedures[1] but these also may not be helpful. Members of an L.L.C. should not take any comfort in the provisions

[1] 6 Del. C. § 18 - 801

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of the Delaware Limited Liability Company Act as an exit mechanism. Section 18-1802 provides a possible exit mechanism,[2] but recent case law has shown that the Delaware courts are loath to dissolve a limited liability company simply because of changed circumstances, including bad economic conditions or a failure by the company to perform as anticipated.

Without some forethought and careful drafting of the operating agreement, a member wanting to withdraw or remove another member may find that neither the operating agreement nor the Delaware Limited Liability Company Act will provide meaningful options.

BUY-OUT/VALUATION

We have discussed "shotgun buy/sell" arrangements in a previous issue. A shotgun / buy-sell provision allows a member to initiate a buyout process by offering to either buy the other member's interest at a specified price or sell its own interest using the same pricing methodology. Generally, the other member has the option to either (i) accept the offer and sell their interest at the proposed price or (ii) decline the offer and become the buyer at that price. While clients generally like this type of provision as it incentivizes members to carefully consider the valuation of the company, and can provide a swift resolution to disputes over ownership interests within the L.L.C., such a provision generally favors the party with the deepest pockets and the result can be inequitable.

In the hypothetical fact scenario mentioned above with two members, the member with the production capability would potentially have to overpay to take out the other member. At the same time, the member with the sales knowledge and contacts that didn't eventuate would not be in a position to put any value on the company as without the production partner, the sales business would have little value.

Often, the splitting of partnership interests is much easier and less expensive if the L.L.C. Agreement sets out a structured roadmap for valuing the company and methodology and timeframe for one partner buying out the other. A carefully drafted agreement can match an exit mechanism with an exit trigger which will not only incentivize the members to maximize value but will provide for an orderly exit when the trigger is activated.

FUTURE OBLIGATIONS

Ancillary agreements with landlords, banks and vendors should be carefully reviewed in connection with exiting a partnership. Apart from change in control restrictions and the implications of that on various contracts, the member exiting should ensure that he or she is no longer a guarantor on any of the L.L.C.'s obligations. It is common for a lease of premises to contain a personal rent guarantee from one or both partners. Leaving the partnership does not release the exiting partners from guarantee obligation, and the landlord's consent would be needed for a lease amendment. While this is typically doable in conjunction with the global settlement,

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[2] "On application by or for a member or manager the Court of Chancery may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement."

it can be time consuming, and the landlord should be informed in the early stages of the discussions around breaking up the partnership. Members of a troubled L.L.C. often are loath to reach out to the landlord, for fear of triggering adverse responses by the landlord.

FURTHER ASSURANCES

The partners should agree to execute any further required documents to finalize the breakup and the exiting partner should see an amended and restated operating agreement evidencing the new ownership together with a general release from the remaining partners, releasing the departing member of the L.L.C. from all future obligations and liabilities of the company.

CONCLUSION

Breaking up a business partnership can be difficult and emotional. Often these closely held partnerships are between friends or individuals who have worked together previously. When trouble arises, conversations become difficult, but partners should be prepared to discuss ongoing issues and should set time on a regular basis to talk about how the partnership is doing in terms of where they are and where they want to be. The problems that lead to the desire to close a business rarely occur overnight. It is important that partners have frequent conversations so that they are able to spot the early signs of a failing business and either work out a plan to fix the problems or amicably agree to go their separate ways before the relationships sours to a point where any agreement becomes difficult.

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UPDATES & OTHER TIDBITS

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Tags
Corporate Transparency Act
New Jersey
Texas Top Cop Shop
Transition Tax

CORPORATE TRANSPARENCY ACT REMAINS ON HOLD

Will they or won't they? The end of 2024 and beginning of 2025 have seen continuous back and forth about the Corporate Transparency Act ("C.T.A."), a reporting law that requires many U.S. companies to disclose their beneficial owners to FinCEN, the financial-crimes regulator of the Treasury Department.

The C.T.A. went into effect in 2024, with existing companies (*i.e.*, those formed before 2024) having until the end of 2024 to submit their reports. However, on December 3, 2024, a U.S. Federal District Court in *McHenry v. Texas Top Cop Shop Inc.* [1]imposed a preliminary, nationwide injunction based on its finding that the C.T.A. was likely unconstitutional. The U.S. Federal Court of Appeals for the 5th Circuit then repealed the injunction on December 23, only for another panel of the 5th Circuit to reinstate the injunction three days later. More recently, the Supreme Court upheld the government's appeal and vacated the injunction.

But in a further twist to the tale, the C.T.A. remains unenforceable. This is because on January 7, a different judge in the same U.S. Federal District Court that decided *Texas Top Cop Shop* issued a separate injunction against the C.T.A. in *Smith v. U.S. Dept. of the Treas*.[2] The Supreme Court's order applies only to *Texas Top Cop Shop* and not *Smith*. Therefore, the C.T.A. continues to be enjoined, which was confirmed by FinCEN in an update to its website posted on January 24, 2025.

Given recent history, that could change again quickly. If the C.T.A. becomes enforceable again, FinCEN will likely post new deadlines for companies to submit reports, as it did when the 5th Circuit initially lifted the *Texas Top Cop Shop* injunction.

TRANSITION TAX NOT APPLICABLE IN NEW JERSEY

Last year saw a highly publicized tax case in *Moore v. U.S.,*[3] where taxpayers unsuccessfully argued that the "transition tax" was unconstitutional. The transition tax, enacted in 2017, required U.S. shareholders of certain closely held foreign corporations to pay a one-time tax on accumulated but undistributed income earned by the foreign corporations between 1986 and 2017.

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1 No. 4:24-CV-478; the case was formerly *Garland v. Texas Top Cop Shop Inc.*

2 No. 6:24-CV-336 (2025).

3 602 U.S. 572 (2024).

The transition tax is part of a broader anti-deferral regime known as Subpart F, which requires U.S. Shareholders of controlled foreign corporations ("C.F.C.'s") to include certain items of the C.F.C.'s income in their own income on a current basis, even if the income was not distributed.

In many ways, Subpart F Income resembles a deemed dividend from a C.F.C., although the law does not explicitly make the comparison. It was under this theory that New Jersey levied tax on the accumulated earnings attributable to Archit and Mona Amin, who paid the federal transition tax but did not do so for New Jersey. New Jersey argued that the transition tax amount was essentially a taxable dividend.

The taxpayers prevailed in court.[4] Without a state-level equivalent of Subpart F, New Jersey relied on the dividend theory to bring its case. But the court noted that New Jersey's definition of "dividend" required earnings to be actually distributed to shareholders. The Subpar F inclusion was found not to be a dividend. The court further pointed out that New Jersey never revised its definition of the term "dividend" to incorporate Subpart F. After the complex constitutional wrangles in Moore, this was a more straightforward sequel.

4 *Amin v. Dir.,* Div. of Tax'n, N.J. Tax Ct. No. 007430-2022 (2024).

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