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INSIGHTS

FURTHER DEVELOPMENTS FOR U.K. NON-DOM INDIVIDUALS

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USUFRUCT, BARE OWNERSHIP, & U.S. ESTATE TAX: AN UNLUCKY TRIO

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EDITORS' NOTE

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

- **Further Developments for U.K. Non-Dom Individuals.** A significant claw back of benefits for individuals with Non-Dom status was first announced in the Summer Budget of 2015. In August, H.M.R.C. proposed implementing legislation in a follow-up consultation document. Specific benefits covered included inheritance tax for shares of envelope companies owning U.K. residential real property, deemed domicile rules for long-term U.K. residents, and several provisions to lessen the impact of these changes. Gary Ashford of Harbottle & Lewis, London explains.

- ***Usufruct*, Bare Ownership, and U.S. Estate Tax: An Unlucky Trio.** Splitting ownership into *usufruct* and bare ownership is a common estate planning technique in several civil law countries. However, this planning technique may have adverse tax consequences when the holder of the bare legal title resides in the U.S. Fanny Karaman and Stanley C. Ruchelman explain the civil law inheritance tax benefits and the pitfalls that are encountered in the U.S.

- **I.R.S. Advises Scrutiny Required for Partner's Foreign Earned Income.** A partner of a U.S. law firm formed as an L.L.P. may lose expat tax benefits when he is assigned to an office outside the U.S. The foreign earned income exclusion and the foreign tax credit limitation may not apply to the partner's full share of partnership profits. Elizabeth V. Zanet examines an International Practice Unit ("I.P.U.") published by the I.R.S., which cautions that the U.S. tax treatment of income differs: favorable treatment for guaranteed payments and unfavorable treatment for distributive shares of total profits.

- **O.E.C.D Targets Hybrid Mismatch Arrangements Using Branch Structures.** Advisers who took comfort in the belief that the B.E.P.S. Project's attack on hybrid mismatches did not apply to transactions between two branches of the same entity were disappointed when the O.E.C.D. released draft recommendations for domestic law that would neutralize income inclusion mismatches using branches located in different countries. Kenneth Lobo and Beate Erwin explain that D/NI, DD, and indirect D/NI outcomes are not legitimized when branches, rather than affiliates, are used.

- **Treasury Attacks European Commission on State Aid – What Next?** On August 30, 2016, the European Commission ordered Ireland to claw back €13 billion ($14.5 billion) plus interest from Apple after favorable Irish tax rulings were deemed to be illegal State Aid. The U.S. Treasury Department issued a white paper shortly before the decision staking out the reasons why the European Commission crusade is unjustified, especially in relation to its retroactive effect. This trans-Atlantic conflict is placed in context in an article by Kenneth Lobo and Beate Erwin.

- **Corporate Matters: Initial Steps in Selling a Privately Held Corporation.** Disclosure of information is a problem often encountered when representing the owners of a privately held business that is for sale. What should be disclosed? What should remain confidential? How is confidential information protected? These and other matters will arise in connection with the sale of a business. Owners often hate disclosure, while prospective purchasers demand as much as possible, and delegate the task to officious lawyers and accountants.

- **Uproar Over Proposed §385 Regulations: Will Treasury Delay Adoption?** Earlier this year, the U.S. Treasury Department issued comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity. Not surprisingly, significant pushback has been encountered from members of Congress, professional bodies, and affected taxpayers. It seems that the one-size-fits-all approach contains many defects. Philip R. Hirschfeld and Stanley C. Ruchelman explain.

- **Projected Tax Expense – Can It Be Computed on the Back of Envelope?** Tax advisers are often asked to project tax expense arising from an anticipated transaction by multiplying book income by the statutory tax rate. This seems like an easy task, but a reliable answer is anything but straightforward, as more jurisdictions enact alternative minimum tax ("A.M.T.") regimes to protect the tax base. Galia Antebi, Kenneth Lobo, and Stanley C. Ruchelman explain how the A.M.T. works in the U.S. and how a comparable tax in Puerto Rico lead to a proposed 132% effective tax rate.

- **Updates & Other Tidbits.** Fanny Karaman, Galia Antebi, and Nina Krauthamer address recent developments involving (i) the U.S. Treasury Department's Priority Guidance Plan in the international arena, (ii) the negotiation of a new income tax treaty between the U.S. and Ireland, and (iii) a recently discovered abuse when a disregarded L.L.C. owned by a single foreign member sells U.S. real estate.

We hope you enjoy this issue.

- The Editors

FURTHER DEVELOPMENTS FOR U.K. NON-DOM INDIVIDUALS

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Summer is well and truly over, and as everyone started back at the office, H.M.R.C. published its latest consultation document (the "Current Consultation Document") on the proposed changes to be introduced for non-domiciled individuals ("Non-Doms") starting April 6, 2017.

ORIGINAL CONSULTATION DOCUMENT

Some aspects of the proposed changes, including a consultation document (the "Original Consultation Document") and draft legislation, were published in September 2015 as a consequence of announcements made by the U.K. government in the Summer Budget of 2015. The writer commented upon these in a previous edition of *Insights*.[1]

Those proposed changes were as follows:

- Any individual who is a Non-Dom who was born in the U.K. and has a U.K. domicile of origin will be deemed to be domiciled whenever they are resident in the U.K.
- Any individual who is a Non-Dom who has been resident in the U.K. for 15 out of the previous 20 tax years will be deemed to be domiciled in the U.K. from that point on.

At the time of the original announcements, H.M.R.C. also proposed the introduction of relief from the effect of the changes for Non-Doms who would become deemed domicile as of April 6, 2017. For example, one suggestion was to allow Non-Doms to settle assets into a trust in advance of the changes coming into effect.

The Original Consultation Document also stated that H.M.R.C. would take steps to change the rules regarding the holding of U.K. property in overseas corporate structures. Currently, the rules provide certain opportunities to reduce or extinguish stamp duty charges, and to treat both the shares of the company and, as a consequence, the underlying property as excluded from an estate for the purposes of U.K. inheritance tax ("I.H.T.").

SECOND & CURRENT CONSULTATION DOCUMENT

The Current Consultation Document sets out further details and draft legislation regarding the proposals, including protections against the deemed domicile measures and changes to the treatment of property held in overseas corporate structures.

[1] Gary Ashford, "U.K. Non-Dom Taxation – Where It Is and Where It Is Going," *Insights* 10 (2015).

Some measures are not yet fully covered, such as the Anti-Avoidance Transfer of Assets Abroad rules. It is anticipated that further documents will arrive before April 6, 2017, but the Current Consultation Document provides considerable assistance and guidance on what can be done in anticipation of the April 6, 2017 deadline.

SPECIFIC ISSUES COVERED

Inheritance Tax on U.K. Individual Property

H.M.R.C. previously advised that starting on April 6, 2017, it plans to bring U.K. residential property that is held in an overseas corporate structure under the I.H.T. net. It will do this by introducing legislation that will prevent property held in an overseas corporate structure from being treated as excluded property (and therefore outside the I.H.T. net) if the value of the shares is derived from an interest in a dwelling in the U.K. This rule will apply to both Non-Doms and trusts with settlors or beneficiaries who are Non-Doms.

Background

Many U.K. residential or investment properties are held via corporate structures, and many of those companies are located overseas. In the case of a U.K.-resident Non-Dom, the shares of an overseas company would be non-U.K. situs property. As a result, the underlying property could potentially be treated as excluded property for I.H.T. purposes, so long as the Non-Dom is not yet deemed domiciled and has not settled the shares into an offshore trust.

H.M.R.C. is proposing that property held in overseas corporate structures where the underlying value relates to U.K. property shall no longer qualify as excluded property for I.H.T.

Properties Affected

H.M.R.C. is proposing the application of the new rules to any property which is a "dwelling." The definition of a dwelling was introduced in Finance Act 2015 for the purposes of capital gains tax on disposals by nonresidents of residential property in the U.K. This includes

- Any building which is used or suitable to be used as a dwelling,
- Any building which is in the process of being constructed or adapted for use as a dwelling, and
- The grounds on which such a building is situated.

The new I.H.T. rules will also apply to trustees. The rules will not have any minimum value threshold, nor does H.M.R.C. intend to provide an exclusion for residential properties that are transferred on arm's length terms to a third party or used as a main home.

Changes of Use

H.M.R.C. acknowledges that a residential property may have previously been used for a nonresidential purpose, and therefore, it proposes the introduction of a two-year rule similar to that which currently applies for the purposes of I.H.T. Business

Property Relief ("B.P.R."). This rule states that if the shares in an overseas corporate structure derive their value from a U.K. property I.H.T. will apply if the property was used for a residential purpose at any point in the two years before the I.H.T. event. There will be provisions to apportion I.H.T. charges on a property that has been used for both residential and other purposes at the same time (*e.g.*, property consisting of commercial premises with a flat above).

"H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime."

Debts

In Finance Act 2013, H.M.R.C. tightened the rules by which debt could be used to reduce a liability for I.H.T. purposes. H.M.R.C. has confirmed that it will continue to apply these rules in the new proposals.

As such, any debts which are not related to the property will not be taken into account when determining the value of the property subject to I.H.T., and H.M.R.C. intends to disregard any loans made between connected parties. Furthermore, where an offshore entity holds debts related to U.K. residential property alongside other assets, it will be necessary to take a *pro rata* approach with regard to that debt in calculating the amount of the I.H.T. base.

Administrative Matters

H.M.R.C. is proposing new reporting requirements so that a property cannot be sold until any outstanding I.H.T. charges are paid. Under this provision, a new liability may be imposed on any person who has legal ownership of a property, including the directors of a company that holds a property, to ensure that I.H.T. is paid. The relevant legislation will be published later in 2016. These rules will apply to all chargeable events that take place after April 6, 2017.

Deemed Domicile Rules for Long-Term U.K. Residents

Background

Prior to the release of the Current Consultation Document, H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime. A specific deemed domicile rule already exists for I.H.T. purposes, under which Non-Doms resident in the U.K. for 17 out of the previous 20 years are deemed to be domiciled in the U.K (the "17/20 Rule"). However, the new proposal would establish a general cap on the number of years that the Non-Dom regime could apply, after which any resident Non-Dom would be taxed on the arising basis[2] in the U.K. in the same manner as all other U.K.-resident and domiciled citizens.

H.M.R.C. has already issued draft legislation for this proposal. It will deem those individuals who were U.K. residents in 15 out of the previous 20 tax years as domiciled in the U.K. for both income tax and capital gains tax purposes (the "15/20 Rule"). The proposed new rule will essentially follow the same principles as the 17/20 Rule, albeit for a shorter threshold period, and will include any years in the U.K. under the age of 18. The new shorter deemed domicile period will also apply for I.H.T. and will replace the 17/20 Rule.

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2 Under the arising basis, income is taxed when and as it arises. Remittance to the U.K. is immaterial.

H.M.R.C. has confirmed that an individual can "lose" their U.K. domicile status if they become nonresident and spend at least six years overseas (four years for I.H.T. purposes).

Updates Within the Current Consultation Document

An interesting and significant point in the Current Consultation Document is that H.M.R.C. has confirmed that the residence tests will follow current law, which is a combination of the Statutory Residence Test for tax years 2012-2013 onwards and existing case law for prior years, as there was formerly no real legislation in this area. Given the historical problems that have arisen from uncertainties over residence under common law, one can see that application of the residence tests may not be as straightforward to apply as H.M.R.C. intends.

In the Current Consultation Document, H.M.R.C. clarified that split tax years will be counted towards one of the 15 years under the proposed deemed domicile rules.

Protections Proposed to Lessen the Impact of the Changes

Capital Gains Tax

H.M.R.C. proposes that individuals who will be deemed domiciled on April 6, 2017 under the 15/20 Rule shall be able to rebase directly-held foreign assets to the market value of the assets on April 5, 2017. Those individuals who become deemed domiciled after April 2017 and those who are deemed domiciled because they were born in the U.K. with a U.K. domicile of origin will not be able to rebase their foreign assets.

Mixed Funds Opportunity

A welcome development within the Current Consultation Document is that H.M.R.C. is introducing a window to clean up mixed funds.

Prior to arrival in the U.K., it is always advisable for a future Non-Dom to segregate his or her banking accounts into pre-arrival capital, income, and gains – in addition to a few other categories. The purpose of this is essentially to maintain the character of each component of the account so that any future remittance to the U.K. will be taxed at the appropriate rate, *i.e.*, 45% income tax, 28% capital gains tax (recently reduced to 20%), and to distinguish capital, which can potentially be brought into the U.K. without any tax charge.

Where segregation has not taken place, mixed funds arise and any future remittance will therefore contain a mixture of the various parts. There are specific rules for mixed funds that essentially tax any part of the funds at the highest rate first (*e.g.*, as income). Without a significant amount of work, H.M.R.C. might well contend that the whole remittance should be taxed at 45%.

Under the latest proposals, Non-Doms with mixed funds will have the opportunity to review the funds and separate out the different parts into clean capital, foreign income, and foreign gains. They will then be able to remit from the newly-segregated accounts as they wish. There will be no requirement for Non-Doms to make remittances from their newly-segregated accounts in any particular order or within any particular period of time.

This special treatment will apply only to mixed funds that consist of amounts deposited in banking and similar accounts. Where the mixed funds take the form of assets, an individual will have to sell any overseas assets during the transitional window and separate the sale proceeds in the same way as any other money.

To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds. This opportunity will be available to any Non-Dom, including those born in the U.K. without a U.K. domicile of origin and individuals who will be deemed domiciled under the new rules. An individual need not be resident in the U.K. in April 2017. This window for this benefit will last for one tax year from April 6, 2017.

The matter of whether a trust, treated as a relevant person under the remittance rules, will also be able to clean up its mixed funds is currently not clear. It would appear logical to allow this, but we will have to wait and see.

> ***"To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds."***

Nonresident Trusts

Nonresident trusts have always been very useful to Non-Dom clients, as they allow for non-U.K. situs assets to remain outside the U.K. estate for I.H.T. purposes, even beyond the point that the 17/20 Rule starts to apply, when settled before that point. Additionally, Non-Dom settlors and/or beneficiaries claiming the remittance basis are only taxed on income or gains to the extent they are remitted to the U.K.

H.M.R.C.'s proposal to deem those who fall under the 15/20 Rule as U.K. domiciled for all taxes potentially has significant effects for Non-Doms holding assets in non-resident trusts. Whilst the proposed rule simply reduces the threshold of the current I.H.T. deemed domicile rule by two years, any Non-Dom individual who is deemed domiciled would not be able to use the remittance basis. As a result, where these individuals receive distributions or have an interest in income and gains from a trust, they would then be liable for tax on any resulting income or gains.

To limit the burden of the proposed changes, H.M.R.C. has again proposed certain protections. One proposed protection is that Non-Doms who set up offshore trusts before they are deemed domiciled under the 15/20 Rule will not be taxed on trust income and gains that are retained in the trust or its underlying entities. Another proposed protection is that excluded property trusts will have the same I.H.T. treatment as at present (except where there is U.K. property, as discussed below).

Proposed Changes for Specific Taxation Areas for Nonresident Trusts

Attribution of Gains to Settlors (§86 T.C.G.A. 1992)

Section 86 taxes chargeable gains on any individual who is resident and domiciled in the U.K. and who has an interest in settled assets that are held in a nonresident trust or which are attributable to the trustees via an underlying company. The current §86 rules do not apply to Non-Doms, meaning that Non-Doms with an interest in an offshore trust will only be taxed on gains that are distributed to them and, even then, only when those gains are remitted to the U.K.

Under the proposed changes, §86 will be extended to include Non-Doms who are deemed domiciled. In order to mitigate the effects of this new application, H.M.R.C. is proposing to tax the Non-Dom only on any gains in relation to a trust established prior to becoming deemed domiciled when any distribution is made to the Non-Dom or a member of the Non-Dom's family. In this context, a family member is defined as the settlor, the spouse, or children under the age of 18. Additions made to a trust after the changes come into force will also potentially take away the protections.

The protections above will not be afforded to any person who is deemed domiciled as a result of having been born in the U.K. with a U.K. domicile of origin. Furthermore, any gains being taxed on the settlor under these proposals will be matched to the underlying gains in the nonresident trust.

Attribution of Gains to Beneficiaries (§87 T.C.G.A. 1992)

Section 87 taxes any U.K.-resident individual on capital payments they receive from a nonresident trust to the extent that there are chargeable gains arising in that trust. The legislation applies regardless of the individual's domicile status and includes, *inter alia*, the settlor of the trust. However, those currently taxed under §87 can elect to apply the remittance basis.

Following the introduction of the new deemed domicile rule and the proposed changes to §86 mentioned above, settlors of trusts will no longer be taxed under this clause. It is proposed that U.K.-resident individual beneficiaries who receive capital payments or benefits from a nonresident trust or underlying entity and who are deemed to be domiciled in the U.K. will be subject to capital gains tax under §87, regardless of where the benefits are received. The current rules of matching underlying gains in the nonresident trust to distributions will continue.

Settlements Legislation (§624 I.T.T.O.I.A. 2005)

The settlements legislation is an income tax provision which taxes any income of an individual settlor who has retained an interest in a settlement, including a nonresident trust. The legislation also taxes the settlor on any income arising to the settlor's unmarried minor children, on capital payments from a nonresident trust, on loans, and on capital payments made by bodies associated with a nonresident trust. Currently, where U.K.-resident Non-Doms are potentially taxed under this provision, those who claim the remittance basis are taxed only on foreign-source income remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident deemed domiciled individuals on a worldwide arising basis, and where the legislation applies, they may be liable for tax on all income arising in the nonresident trust. H.M.R.C. is proposing additional protections so that deemed-domiciled individuals will be taxed on income of a nonresident trust set up before they were deemed domiciled only to the extent that a "family benefit" is conferred. A family benefit is conferred where any of the protected income is applied for the benefit of or paid to any of the following:

- The settlor
- The spouse
- A minor child or grandchild
- A closely-held company in which a participator falls within the scope of the settlements legislation
- The trustees of a settlement of which a beneficiary falls within the scope of the settlements legislation

- A body connected with such a settlement

Anti-Avoidance for Transfers of Assets Abroad (Chapter 2, Part 13 I.T.A. 2007)

The Transfer of Assets Abroad legislation ("T.o.A.A.") is anti-avoidance legislation designed to prevent U.K.-resident individuals from avoiding U.K. income tax by transferring the ownership of assets to persons abroad while still being able to enjoy the benefit of the income generated by those assets. Essentially, T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements. H.M.R.C. taxes transferors on the underlying income, or transferees (including beneficiaries) on the amounts they receive. Currently, T.o.A.A. allows for any individual claiming the remittance basis to be liable for income tax only on U.K.-source income and foreign income that it is remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident, deemed-domiciled individuals on any foreign income arising in or paid by a structure, wherever it is received. However, H.M.R.C. is proposing changes that partially remove the application of the provisions of the T.o.A.A. legislation that would affect deemed-domiciled settlors who set up a nonresident trust before they become deemed domiciled. This is to prevent them from being taxed on the foreign income of the trust or any underlying entity paying out dividends to the trust.

Under the proposed new rules, H.M.R.C.'s intention is that, rather than being taxed on the arising basis, foreign-source income will be taxed at the time any benefits received. If the settlor, the spouse, a minor child, or other relevant person receives any actual benefits from the trust – *e.g.*, by way of an income or capital distribution or enjoyment of trust assets – the distribution will trigger the imposition of tax on the settlor to the extent that it can be matched against relevant foreign income arising in that year.

"T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements."

The full details of the proposed changes to the T.o.A.A. provisions have yet to be released. However, the details provided to date appear to suggest that some of the same principles under which beneficiaries are currently taxed on gains under §87 T.C.G.A. (see above) will be applied to the underlying income of the trust (*i.e.*, the distribution will be matched and taxed accordingly). H.M.R.C. has advised that it will publish further details on these proposed changes later in the year.

Born in the U.K. with a U.K. Domicile of Origin

H.M.R.C. has already stated that it proposes to treat any individual born in the U.K. with a U.K. domicile of origin as U.K.-domiciled while they are resident in the U.K.

Many, if not all, of the protections being proposed by H.M.R.C. to lessen the impact of the April 6, 2017 changes will be denied to those caught under this provision. This includes the opportunity to make settlements into nonresident trusts prior to arrival in the U.K. The resulting nonresident trusts would be treated as relevant property trusts once the individual becomes resident in the U.K.

However, H.M.R.C. is offering some relief from these provisions. For the purposes of I.H.T., the individual will not be treated as being domiciled in the U.K. until they have been resident for at least one of the two tax years prior to the year in question.

This would apparently provide some opportunity to settle matters in trust before becoming resident in the U.K. Whilst the resulting trust would be a relevant property trust when the individual is resident, the assets may still effectively sit outside the U.K. estate for I.H.T. purposes. However, it is understood that these individuals will be taxed on a worldwide basis for income tax and capital gains from the point they become U.K. residents.

Business Investment Relief

Building on the government's 2015 Autumn Statement, H.M.R.C. has also set its interest on ways business investment relief ("B.I.R.") may be modified to encourage foreign investment in U.K. business by remittance basis users. Clearly, given June's Brexit referendum result, one may suggest that this issue has risen to even greater prominence than when the 2015 Autumn Statement was first issued.

For those unfamiliar with B.I.R., it provides an exemption to the remittance basis rules that was introduced on April 6, 2012. B.I.R. helps U.K. businesses to attract inbound investment by allowing individuals who use the remittance basis to bring overseas income and gains to the U.K. without any tax liability if it is done for commercial investment purposes. The scheme effectively treats funding for qualified investments as if not remitted to the U.K. and therefore not liable to tax.

The range of companies in which a qualifying investment can be made under the scheme is quite wide. The definition includes an investment in:

- A company carrying on a commercial trade or preparing to do so, including one whose activities consist of generating income from land,
- A company carrying out research and development activities,
- A company making commercial investments in trading companies, and
- A holding company of a group of trading companies.

There are no restrictions preventing the scheme from being used for investments in a company with which an investor has a separate involvement, such as holding a director's position and receiving arm's length compensation for services provided in the ordinary course of business. Any investment must be made within 45 days of the date on which the funds are brought into the U.K.

Unlike other government schemes designed to encourage investments, there is no monetary limit on an individual's investments under B.I.R. However, the scheme is not available for investments to acquire existing shares nor is it available for investments in companies that are listed on a recognized stock exchange.

H.M.R.C. has indicated that any changes to B.I.R. would feature in Finance Bill 2017 and therefore be introduced on April 6, 2017.

CONCLUSION

Despite the Brexit vote, the U.K. government appears to be committed to limiting some of the benefits of the Non-Dom rules. However, for the newly arrived non-U.K.-born Non-Dom, there are still great opportunities and potentially 15 years of full benefits under the Non-Dom regime.

Even when the 15-year threshold has been reached, the individual in question has choices. The individual might, for example, settle assets into a trust. Provided that there are no distributions to family members, the assets could potentially sit within that trust without encountering taxable consequences. Various trust-related options will likely be considered between now and April 6, 2017, along with various other options that may provide for income tax deferment, such as an offshore life insurance bond.

Alternatively, some Non-Doms may actually decide to leave the U.K. – at least for a sufficient amount of time to reset the 15-year clock. For those who choose to do this, it is worth remembering that, depending on the circumstances, they may still have quite a generous allowance of days, which grants them continued access to the U.K. Departure need not amount to an all-or-nothing solution.

USUFRUCT, BARE OWNERSHIP, AND U.S. ESTATE TAX: AN UNLUCKY TRIO

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Tags
Bare Ownership
Estate Tax
France
Usufruct

INTRODUCTION

Splitting ownership into *usufruct* and bare ownership is a common estate planning technique in several civil law countries. However, when imported to the U.S., this planning technique may have adverse tax consequences under the general inclusion rules of Code §2033 or the retained power rules of Code §2036. This article discusses the U.S. estate tax issues that may arise when the *usufruct* holder is a U.S. resident at the conclusion of his or her lifetime.

SUMMARY OF *USUFRUCT* V. BARE OWNERSHIP

In civil law countries, ownership attributes can be divided into two separate rights:

- *Usufruct*, which gives its holder the right to the enjoyment of the underlying asset and the right to the income generated by the underlying asset
- Bare ownership, which essentially gives its holder the right to transfer the underlying asset

Generally, a *usufruct* right lasts for the lifetime of its holder. It can be compared to the life estate found in common law systems.[1] It can also be set up for a shorter period of time in certain countries. Upon the death of the holder of the *usufruct* interest, or at the end of its term if shorter, the *usufruct* right is automatically transferred to the bare owner, thereby providing the bare owner with full title to the underlying property.

As a general estate planning tool, parents transfer the bare ownership to their children while retaining the *usufruct* for their lifetime. This provides them with the right to the income and the enjoyment of the property until their death. As the transfer of the bare ownership is less than the transfer of the full ownership, the gift tax base is reduced, thereby resulting in a lower tax at the time the plan is initiated.

As an example, in France the French Tax Code provides for the following arbitrary valuation of the bare ownership and the *usufruct*, based on the age of the *usufruct*

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1 Rev. Rul. 66-86. However, see also P.L.R. 9121035, in which the *usufruct* interest was determined as constituting a trust. In that ruling, the decedent named her son as heir in the entirety. However, he had the option to renounce his heirship. The decedent's will provided that, in that event, her son would be entitled to the *usufruct* right in all her properties, including operating businesses, with the bare ownership passing to her son's children. Her will further provided that her son would be the administrator of her estate. The terms of her will thus created a trust instrument.

holder at the time of the transfer.[2] The expressed percentages must be applied to the value of the full legal title.

Age of the *Usufruct* Holder	*Usufruct* Value	Bare Ownership Value
Less than:		
21 completed years	90%	10%
31 completed years	80%	20%
41 completed years	70%	30%
51 completed years	60%	40%
61 completed years	50%	50%
71 completed years	40%	60%
81 completed years	30%	70%
91 completed years	20%	80%
More than:		
91 completed years	10%	80%

Upon the parents' death, the *usufruct* is automatically carried over to the children, free of inheritance tax, thereby granting full ownership in the property to the children.

U.S. ESTATE TAX CONSEQUENCES

While under applicable foreign laws the death of the *usufruct* holder and the ensuing transfer of the decedent's *usufruct* interest to the bare owner is not a taxable event for inheritance tax purposes, the U.S. estate tax analysis may differ.

Several scenarios exist. One possible scenario is that the decedent's death creates a *usufruct* interest. Another possible scenario is that the *usufruct* interest was received by the decedent during his or her lifetime. Yet another scenario is that the decedent retained the *usufruct* interest during his or her lifetime while transferring the bare ownership. These scenarios carry different estate tax consequences.

Code §2033 – Estate Inclusion

Code §2033 provides that "the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

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[2] Article 669, I of the French Tax Code.

The entire transferred property includes all property, whether real or personal, tangible or intangible, and wherever situated, beneficially-owned by the decedent at the time of death.[3]

In the context of the death of a U.S. *usufruct* holder, the question posed is whether the value of the *usufruct* interest plus the value of bare legal title computed as of the date of death are included in the decedent's estate. Such inclusion would essentially cancel out the benefits of the foreign estate planning.

““Upon the parents' death, the usufruct is automatically carried over to the children, free of inheritance tax, thereby granting full ownership in the property to the children.”

No Decrease in Value of the Taxable Estate for a Usufruct *Interest Created Upon Death in Property Owned by the Decedent*

In *Estate of Jeanne Lepoutre v. Commr.*,[4] a husband and wife were French citizens and residents at the time of their marriage. Their *ante nuptial* agreement provided that the applicable marital regime was a community property regime under which each spouse had an undivided 50% interest in the property. In addition, upon the death of the first spouse, the surviving spouse was entitled to the *usufruct* interest of the deceased spouse for the remainder his or her life or until the surviving spouse remarried.

The husband and wife were domiciled in Connecticut at the time of the wife's death. Upon her death, an estate tax return was filed by the estate, and no part of the community property was included in her taxable estate on the return. In part, the position of the decedent's estate was that the decedent was not the owner of any portion of the community property under the matrimonial regime created by the *ante nuptial* agreement. Instead, the decedent possessed a mere expectancy of ownership with regard to her portion of the community property. That expectancy terminated upon her death because she was survived by her husband. In the alternative, the position of the estate was that the value of the surviving spouse's *usufruct* should be excluded from her estate.

Upon examination, the I.R.S. increased the taxable estate by the wife's 50% interest in the community property. The estate petitioned the Tax Court for a redetermination of tax.

The questions presented to the court were (i) whether 50% of the community property of the decedent and her husband was includible in her taxable estate under Code §2033, and (ii) if so, whether the value of the *usufruct* reduced the value of the wife's interest in the community property subject to estate tax.

The court found that, based on the couple's French marital regime, 50% of the community property had to be included in the decedent's gross estate under Code §2033. The reasoning of the court is an interesting read,[5] but it is beyond the scope of this article.

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3 Treas. Reg. §20.2033-1(a).

4 *Estate of Jeanne Lepoutre v. Commr.*, 62 T.C. 84, (1974).

5 Relying on *Estate of Paul M. Vandenhoeck v. Commr.*, 4 T.C. 125 (1944), the court determined that, under French marital property law, the interest of a wife in the community property is a present interest that is equal to that of a husband. It did not matter that the husband exercised management and control over the community property.

Concerning the *usufruct* interest enjoyed by her husband, the court disallowed any reduction in value. The court reasoned as follows:

> [T]he *ante nuptial* agreement provided for rights in the surviving spouse only upon the death of the other spouse and therefore under the Federal estate tax law was in the nature of a testamentary disposition and a transfer of an interest in property at the death of the first to die.

<u>*Inclusion of* Usufruct *Right Received from Pre-Deceased Husband in a Decedent's Estate*</u>

When the underlying asset of the *usufruct* right is a consumable asset, such as money, the bare title holder generally has a claim to the value of the asset transferred to the *usufruct* holder.

In P.L.R. 9223006, a surviving spouse received a *usufruct* right to a note that her deceased husband held at the time of his death. The husband's estate elected to have the property treated as qualified terminable interest property. The value of the husband's estate was reduced by the amount that passed to his wife.[6] To offset the loss of estate tax revenue, the property will be included in the wife's estate at the conclusion of her lifetime.[7]

The origin of this note was a sale by the deceased husband of his business. He elected to report the gain on the sale under the installment method. The wife, in her capacity as *usufruct* holder after his death, had the right to use the funds received under the note and paid taxes on these funds accordingly. The gain represented income in respect of a decedent for the widow.[8]

Louisiana law was the applicable law. It provided that, in the case of a *usufruct* right to a consumable asset such as a promissory note, the *usufruct*uary is required to pay the bare owner either the value of the property at the beginning of the *usufruct* or to deliver the bare owner things of the same quality and quantity. As a result, the bare legal owner had a claim against her estate for the value of the *usufruct* interest less any capital gains tax paid. The appreciation in value of the widow's assets attributable to further investment of the note proceeds is not subject to any claim of the bare legal holder. The note in excess of its value at the time the *usufruct* interest was granted to the wife remained in her estate upon her death and was includable in her taxable estate.

If the underlying asset had been income producing real estate, the bare owner would not have had a claim against the decedent's estate. The full value of the accumulations of income under the *usufruct* right constitutes property included in the decedent's estate in the above scenario.

<u>Code §2036 – Retention of Powers if Decedent Transferred Bare Ownership During Life but Retained *Usufruct*</u>

In the previously mentioned private letter ruling, the *usufruct* holder was never the full owner of the underlying property. Rather, the holder received the *usufruct* from

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6 Code §2056(a).

7 Code §2056(b)(7).

8 Code §691(a).

the owner at the time of the owner's death. The estate planning technique described earlier, in which parents own full title to a given asset and transfer the bare ownership to children while retaining the *usufruct*, is not covered by the private letter ruling. This can lead to unattractive estate tax results for parents who move to the U.S. after the *usufruct* arrangement has been entered.

Code §2036 provides for the inclusion in an individual's taxable estate of property transferred during his or her lifetime, by trust or otherwise, when the transferor retained certain rights in the underlying property. This applies to transfers under which the transferor has retained certain rights for any of the following periods:

- The transferor's life
- Any period not ascertainable without reference to the transferor's death
- Any period that does not in fact end before the transferor's death

The rights so retained must be either

- the possession or enjoyment of, or the right to the income from, the property; or
- the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The retention of the right to directly or indirectly vote shares of stock in a controlled corporation constitutes a retention of the enjoyment of the transferred property for this purpose.

Thus, Code §2036 applies to a retention of property by a transferor during his or her lifetime, with the following retentions in said property:

- The right to the possession of the property
- The right to the enjoyment of the property
- The right to the income of the property

The amount to be included in the decedent's gross estate is not the value of the transferred interest. Rather, it is the value of the entire transferred property, valued at the time of death.[9] This essentially cancels out the benefits of the foreign estate planning technique.

INCOME TAX MATTERS

The remaining question relates to the computation of gain realized on a taxable disposition of a *usufruct* interest or the sale of a combined interest after the death of the *usufruct* holder. In broad terms, gain is the excess of sales price over basis.

Sale of Gratuitously Received *Usufruct* Interest

Code §1001 deals with the determination of the amount of, and the recognition of, gain or loss upon the disposition of property. Code §1001(e)(1) provides that:

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[9] Treas. Reg. §20.2036-1(c)(1)(i).

> [i]n determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.[10]

As a result of this provision, a holder of a *usufruct* interest has a zero basis in that interest for purposes of determining the amount realized from its sale when the *usufruct* interest was originally received in a gratuitous transfer.

Sale of Gratuitously Received Combined Interest

A different result is achieved if the *usufruct* interest and the bare legal title are sold in a single transaction. There, a portion of the basis in the property is allocated to the income interest.

Code §1001(e)(3) provides for an exception by stating that

> [Code §1001(e)(1)] shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

In P.L.R. 7101070280A, a decedent left the *usufruct* of his assets to his sister, with the bare ownership going to other individuals. The sister and the bare owners then wished to sell their respective interests in a given property to an unrelated party, thereby providing the unrelated party with the full ownership in the underlying asset.

The private letter ruling states that in this scenario, where both the *usufruct* interest and the bare ownership are sold to an unrelated party, Code §1014 can be relied on for purposes of determining the basis the *usufruct* holder received in her interest. Thus, her basis in the *usufruct* interest was the fair market value of her interest at the time the split interests were created upon the death of her brother. In the facts contained in the P.L.R., the valuation was made based on the *usufruct* holder's age at the time her brother passed away by applying the actuarial valuation tables of Treas. Reg. §20.2031-7.

Carry-Over Basis for Certain Foreign-Situs *Usufruct* Interests Received at Death

In the case of U.S. children and non-U.S. parents, if the *usufruct* interest relates to property outside the U.S. and that interest passes to the children during a parent's lifetime, there may be no step-up in the basis of the property even though the property would be of a kind that would be included in a U.S. taxable estate if it were located in the U.S.[11]

Generally, the basis of property acquired from or passed from a decedent at the time

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10 Code §1014 provides as a general rule that the basis in property received from a decedent is its fair market value at the date of the decedent's death. Code §1015 provides as a general rule that the donee receives a carryover basis in the *usufruct* interest.

11 If the property were in the U.S., all the conditions of Code §2036 would be met by reason of the parent's retention of the *usufruct* interest, which is a retained interest.

of death is the property's fair market value.[12] The terms "property acquired from" or "property passed from" a decedent include property acquired by reason of death, form of ownership, or other condition, if the property is required to be included in determining the value of the decedent's gross estate.[13] Thus, for example, a life interest generally is considered property acquired from a decedent if the property is required to be included in determining the value of the decedent's gross estate. However, an exception applies for property not includible in the decedent's gross estate, such as property not situated in the U.S. acquired from a nonresident who is not a citizen of the U.S.[14]

If no step-up is allowed in the basis of the entire property, increased capital gains tax will be incurred by the children in the U.S. when the property is eventually sold.

"In the case of U.S. children and non-U.S. parents, if the usufruct interest relates to property outside the U.S. and that interest passes to the children during a parent's lifetime, there may be no step-up in the basis of the property "

CONCLUSION

A *usufruct* interest can have different consequences depending on the rights that it carries under applicable law and the facts and circumstances surrounding its transfer. While constituting an interesting estate planning technique for foreign law purposes, additional planning is required when the *usufruct* holder moves to the U.S.

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12 Code §1014(a)(1).

13 Code §1014(b)(9).

14 Treas. Reg. §1.1014-2(b)(2).

I.R.S. ADVISES: SCRUTINY REQUIRED FOR PARTNER'S FOREIGN EARNED INCOME

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Tags
Distributive Share
Foreign Earned Income
Guaranteed Payment
I.P.U.

The Internal Revenue Service (the "I.R.S.") recently updated an international practice unit[1] ("I.P.U.") discussing the calculation of the foreign earned income exclusion ("F.E.I.E.") of a partner in a partnership with foreign earned income. I.P.U.'s are written documents used as training materials for I.R.S. auditors. They contain explanations of general international tax concepts and information about specific types of transactions, but they are not precedent. According to the I.R.S., they are designed to reflect changes in the compliance environment, new insights, and experiences. They are available to the public on the I.R.S.'s website.[2]

In the I.P.U., the I.R.S. suggests that a guaranteed payment received by a partner for services performed in a foreign country or a special allocation of foreign earned income to the partner is generally eligible for the F.E.I.E. In other cases, a partner's distributive share will be subjected to heightened scrutiny when under examination. The partner's distributive share will be considered foreign earned income for the purposes of the F.E.I.E. only to the extent of the partner's distributive share of the total earned income of the partnership which is derived from foreign sources, regardless of where he/she works.[3] In such cases, the I.P.U. recommends that the auditor review the partnership agreement, interview the partner, and ask the partner to obtain information and/or a letter from the partnership that provides the separately stated amounts (if they were not provided on the Schedule K-1 and/or if not all partnership earned income was foreign source).

EXCLUSION FOR FOREIGN EARNED INCOME

The I.P.U. walks the auditor through the steps for calculating the F.E.I.E. and makes several cautionary remarks along the way, which provide insight into the issues that may be raised by an auditor during an examination.[4]

Internal Revenue Code (the "Code") §911 contains the exclusion for foreign earned income, which permits a U.S. citizen or a U.S. resident alien who works and lives abroad to exclude some or all of his/her foreign earned income. The exclusion is available only for compensation for personal services performed in a foreign country or countries.

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1 I.R.S., *Calculating Foreign Earned Income Exclusion – Partner in a Partnership with Foreign Earned Income*, DCN: JTO/P/09_06_05-19 (2016).

2 I.R.S., "International Practice Units," last reviewed or modified Aug. 23, 2016.

3 I.R.S., *Calculating Foreign Earned Income Exclusion*, p. 13.

4 For example, the I.P.U. cautions that certain income tax treaties may reclassify U.S.-source income as foreign-source income (*e.g.*, the U.S.-France income tax treaty) and reminds auditors that a taxpayer may not receive a double benefit by taking a foreign tax credit, which may be available under a treaty, that is attributable to amounts excluded from gross income under the F.E.I.E.

“A guaranteed payment received by a partner is considered foreign earned income if it was paid for services performed in a foreign country, regardless of whether the partnership had any profits.”

In order to exclude foreign earned income under Code §911, an individual must

- have foreign earned income (*i.e.*, compensation for personal services performed in a foreign country or countries),
- have a “tax home” in a foreign country, as defined in Code §911(d)(3),
- meet either the *bona fide* residence test or the physical presence test, and
- make a valid election to exclude the foreign earned income by filing Form 2555, *Foreign Earned Income*.

DISTRIBUTIVE SHARE V. GUARANTEED PAYMENT

Although a partnership is a pass-through entity not subject to income tax, it is treated as a separate entity for the purpose of determining the taxable income of the partners. That is, the income, gains, losses, deductions, and credits from the partnership’s operations are determined at the partnership level.[5] These items are then allocated to each of the partners according to the partnership agreement or the rules of Code §704. A partner’s allocable share of the partnership’s income, gains, losses, deductions, and credits is referred to as his/her “distributive share.”[6]

In contrast, payments to a partner in his/her capacity as a partner constitute guaranteed payments under Code §707(c), to the extent that they are made for services or the use of capital, and are determined without regard to the partnership’s net income. Guaranteed payments for services are subject to tax as ordinary income and are generally deductible by the partnership as a trade or business expense.[7] A special allocation of partnership net income to a partner, in his/her capacity as a partner, as compensation for services is treated as a distributive share rather than a guaranteed payment. As the I.P.U. suggests, it may be possible to allocate foreign-source earned income to the partner responsible for such income.

The source of a partner’s income is determined at the partnership level.[8] Therefore, absent a special allocation, a partner in a partnership who performs all of his/her services outside of the U.S. may have a significant portion of income that is sourced in the U.S. and is therefore not eligible for the F.E.I.E. However, a guaranteed payment received by a partner is considered foreign earned income if it was paid for services performed in a foreign country, regardless of whether the partnership had any profits.[9]

PLANNING CONSIDERATIONS

The I.P.U. cautions that if an amount received by a partner does not qualify as a guaranteed payment and the partnership agreement does not specify otherwise, the amount is foreign earned income only to the extent of the partner’s distributive share

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5 Code §§701-704.

6 See Code §§702, 704.

7 Code §707(c).

8 Code §702(b).

9 Code §707(c); Rev. Rul. 81-300, 1981-2 C.B. 143; Rev. Rul. 81-301, 1981-2 C.B. 144; I.R.S., *Calculating Foreign Earned Income Exclusion*, p. 3.

of the total earned income of the partnership which is derived from foreign sources, regardless of where the partner performs the services.[10] However, this result may differ if the partnership agreement specifies that the partner's distributive share is based on partnership foreign earned income. The partnership should properly document the foreign source of the partner's distributive share.

It may also differ if the partner receives guaranteed payments, which to the extent they are received for services rendered in a foreign country, will be foreign earned income.[11] Guaranteed payments for services have other advantages. They are generally deductible by the partnership as a business expense. They may serve to compensate a partner who provides services to the partnership and who needs a steady salary-type payment that might not be proportionate to his/her distributive share.

[10] I.R.S., *Calculating Foreign Earned Income Exclusion*, p. 13.

[11] *Id.*, p. 14.

O.E.C.D. TARGETS HYBRID MISMATCH ARRANGEMENTS USING BRANCH STRUCTURES

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Tags
Action 2
B.E.P.S.
Branch
Hybrid Mismatch
O.E.C.D

Recently, the O.E.C.D. released draft recommendations[1] for domestic law that would neutralize income inclusion mismatches that can occur between payor and payee countries when using a branch structure ("Discussion Draft"). Mismatch arrangements were analyzed in the B.E.P.S. (Base Erosion and Profit Shifting) Action 2 report ("Action 2 Report") that was released in October of last year.[2] According to the O.E.C.D., an amendment to reflect branch rules was needed because the hybrid recommendations outlined in the Action 2 Report did not adequately address mismatches resulting from branch structures.

The recommendations seek to resolve issues where

- a payment is deductible in one country, but not included in another (deduction/no inclusion ("D/NI") outcome);
- a single payment triggers a deduction in both countries (double deduction ("DD") outcome); or
- a deductible payment is set off, by the payee, against income that is not included in the payor and payee countries (indirect deduction/no inclusion ("indirect D/NI") outcome).[3]

The recommendations highlight five situations where a mismatch in a branch scenario is deemed to occur because the residence and branch jurisdictions (*i.e.*, the jurisdictions in which the payor and branch are located – herein the "Residence Jurisdiction" and the "Branch Jurisdiction") take differing views as to the status of the branch. Note that the payment need not be made from a head office to the branch. The only item that matters is how the Residence Jurisdiction and the Branch Jurisdiction differ in their views of the tax status of the branch. The Branch Jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction so that income of the branch is not taxed. In comparison, the Residence Jurisdiction recognizes the branch as if it were a separate entity so that the income of the branch is not included in the income of the head office.

DISREGARDED BRANCH STRUCTURE

In the first structure targeted by the Discussion Draft, A Co (a resident of Country

1 O.E.C.D., *Public Discussion Draft on B.E.P.S. Action 2 Branch Mismatch Structures*, (Paris: O.E.C.D. Publishing, 2016).

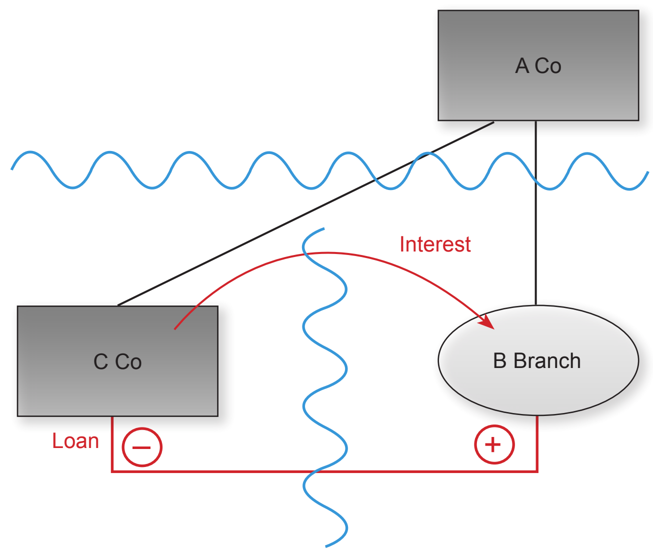
2 Stanley C. Ruchelman, "O.E.C.D. Discussion Drafts Issued Regarding B.E.P.S. Action 2 – Neutralizing Hybrid Mismatch Arrangements," special issue, *Insights* B.E.P.S. Retrospective (2014).

3 See 6, of the Introduction to Part I of the Action 2 Report.

A) owns C Co (a resident of Country C) and B Branch (a branch located in Country B). A Co arranges for a loan to C Co, under terms that involve payments of interest and principal to B Branch. The payment is treated as a deduction for income tax purposes in Country C. Country A (*i.e.*, the Residence Jurisdiction) treats the interest as having been received by a foreign branch that is exempt from tax in Country A, either by reason of a treaty or domestic law. Country B treats B Branch as a representative office of A Co, not as a permanent establishment ("P.E."). Hence, no tax is imposed. Consequently, the payment of interest is deducted by C Co but is not taxed in the hands of A Co or B Branch.

"The mechanics and the resulting tax outcomes from the use of a disregarded branch structure are similar to those of a reverse hybrid."

Figure 1



The mechanics and the resulting tax outcomes from the use of a disregarded branch structure are similar to those of a reverse hybrid, discussed in Chapters 4 and 5 of the Action 2 Report, in that both the Residence Jurisdiction and the Branch Jurisdiction exempt or exclude the payment from income on the grounds that the payment should be treated as received (and therefore properly subject to tax) in the other jurisdiction.

The Discussion Draft explains the reasons for the D/NI result:

- The Residence Jurisdiction treats interest income as paid to a foreign branch and therefore tax exempt under its domestic law, whereas the Branch Jurisdiction does not tax this income absent a taxable presence in its territory under its domestic rules.

- The foreign branch constitutes a P.E. under the treaty between the two jurisdictions. The Residence Jurisdiction is thus required to exempt this income under treaty rules. However, under the domestic law of the Branch Jurisdiction, no taxable presence is created.[4]

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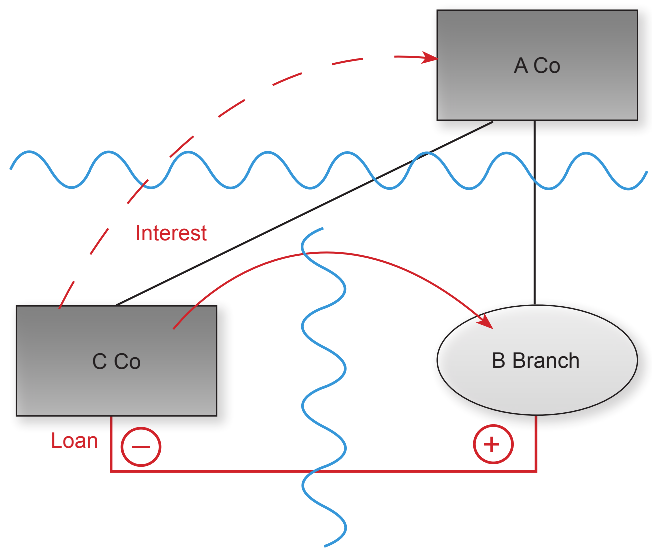
[4] Note that an income tax treaty may only be applied to reduce or eliminate double taxation when income of a person may be taxable in two countries. However, it cannot create a right to taxation where under applicable domestic tax law no right to taxation is granted.

- The foreign branch does not qualify as a P.E. under the applicable treaty. Hence, the Branch Jurisdiction is not entitled to tax the branch's income, while the Residence Jurisdiction's domestic law exempts the payment as foreign branch income under its domestic rules.

DIVERTED BRANCH STRUCTURE

A diverted branch payment has the same structure and outcome as a payment to a disregarded branch except that the mismatch arises not because of conflict in the characterization of the branch but rather due to a difference in the way that payments to the branch are attributed under the laws of the Residence Jurisdiction and the Branch Jurisdiction. The structure is similar to Figure 1, above.

Figure 2



The mismatch arises because B Branch treats the interest payment as if it were paid directly to the head office in Country A, while the head office continues to treat the payment as having been made to B Branch. Consequently, the payment is not subject to tax in either jurisdiction (*i.e.*, a D/NI outcome) either because of different allocation methods applied in each country or an exclusion that is based on nonresident status of B Branch. Similar to the disregarded branch structure, the O.E.C.D. draws parallels to reverse hybrid structures discussed in the Action 2 Report in that the Residence and Branch Jurisdictions exempt or exclude payments from taxation because on a reciprocal basis the payment is construed as received in the other jurisdiction.

O.E.C.D. Recommendations

To resolve the diverted and disregarded branch mismatch problems, the draft recommends conformity of tax treatment at two levels. The first level is conformity between the Residence and Branch Jurisdictions. Under this approach, the Residence Jurisdiction should adjust its branch exemption rules to parallel the treatment in the Branch Jurisdiction. Thus, if the branch country exempts the income, the income would be taxed in the Residence Jurisdiction as if received in that jurisdiction.

Only when the Branch Jurisdiction taxes the income would an exemption be granted by the Residence Jurisdiction.

The second level recommends conformity between the jurisdiction where the payer is resident with the treatment in the Residence and Branch Jurisdictions. Where the mismatch is part of a structured product or where the parties are related, a deduction would be denied to the payer when a diverted branch payment or a disregarded branch payment is made and there is no inclusion in the Residence Jurisdiction nor in the Branch Jurisdiction. A person is considered to be a party to a structured payment when it has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be.

On the other hand, the O.E.C.D. acknowledges that abusive planning exists only where a taxpayer takes advantage of a mismatch in the attribution of profits in the Residence and Branch Jurisdictions. Consequently, in a case where the payment would have been excluded in the Residence Jurisdiction if the head office received the income directly, a deduction should be allowed to the payer in its country of residence. The example identified by the O.E.C.D. focuses on a head office of a tax-exempt entity in its country of residence.

Observations

The recommendation to prevent D/NI treatment is far-reaching and may be construed as introducing a subject-to-tax requirement for exemption of foreign branch payments in the Residence Jurisdiction. This would be infringing upon tax principles in countries with a territorial tax system, which limits taxation to only domestic income and exempts foreign income, subject to different treatment for controlled foreign corporations. This system is found in many European countries, including France, Spain, and the U.K., and also in Canada, Japan, and Australia.[5]

It should also be noted that, in the context of diverted payments, it would be less burdensome if no adjustments were required when the Residence Jurisdiction does not tax this type of income.

DEEMED BRANCH PAYMENT

While the recommendations on diverted or disregarded branch structures deal with third-party payments, a mismatch may also arise in cases where payments are made by the branch to its head office.

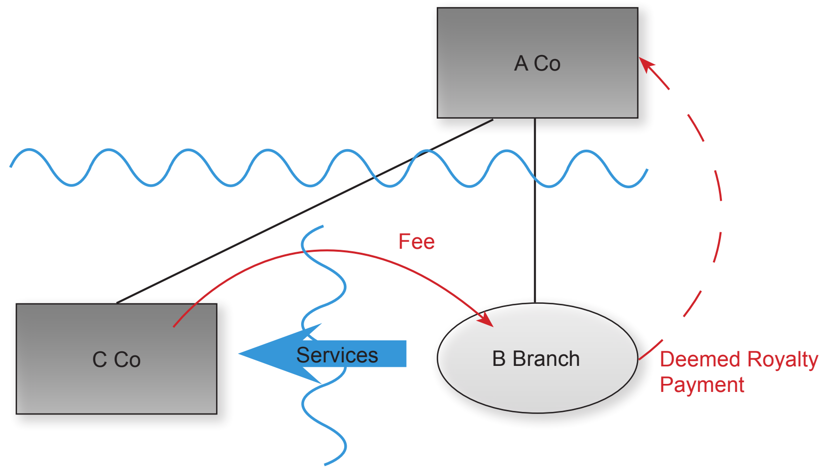
These mismatch arrangements are identified as deemed branch payments. The payments are recognized in the Branch Jurisdiction and thus treated as deductible. However, there is no income inclusion in the Residence Jurisdiction because the payment is deemed to be made internally (*i.e.*, within the same taxpayer) – treatment that is contrary to the separate entity approach mandated by the O.E.C.D. transfer pricing principles in branch scenarios.

To illustrate the mismatch, the Discussion Draft refers to a deemed royalty payment made by the branch located in Country B to its head office located in Country A.

5 While the U.S. is one of the few countries with a worldwide tax system, a change to the territorial system has been requested on various levels, including most recent initiatives.

The branch uses intangible property ("I.P.") owned by the head office in performing services for a related company based in Country C.

Figure 3



In attributing ownership of the I.P. to the head office, Country B recognizes the arm's length payment by the branch for the use of the I.P. and treats it as deductible. Country A does not recognize the royalty payment (because it attributes the ownership in the I.P. to the branch). The service income is exempted from tax in Country A under an exemption or exclusion for branch income that is available in Country A. To the extent the deduction is set off against the branch services income, the deemed payment results in an intra-group mismatch. The services income is neither taxed in Country B (because it is offset by the deemed royalty payment) nor in Country A (due to an exemption or exclusion rule). The O.E.C.D. calls this non-dual inclusion[6] income since the income is not taxed in either country.

"The Discussion Draft recommends the denial of a deduction, at the level of B Branch, for the deemed branch payment to the extent it exceeds dual inclusion income."

A variation of this example takes the mismatch one step further. The deduction could even result in a loss for the branch. This loss could then be used to offset income of another Country B group company under, for example, a group taxation regime. According to the O.E.C.D., this effect is not limited to royalty payments but may also apply to other deemed payments such as interest payments.

O.E.C.D. Recommendations

To remedy this mismatch, the Discussion Draft recommends the denial of a deduction, at the level of B Branch, for the deemed branch payment to the extent it exceeds dual inclusion income.[7] If this recommendation is not implemented into the Branch Jurisdiction's law, the O.E.C.D. proposes that the Residence Jurisdiction should treat the deemed payment as ordinary income to the extent necessary to eliminate the mismatch.

A payment that is treated for tax purposes as made between the branch and head office but which, in practice, represents an allocation of third-party expenses should

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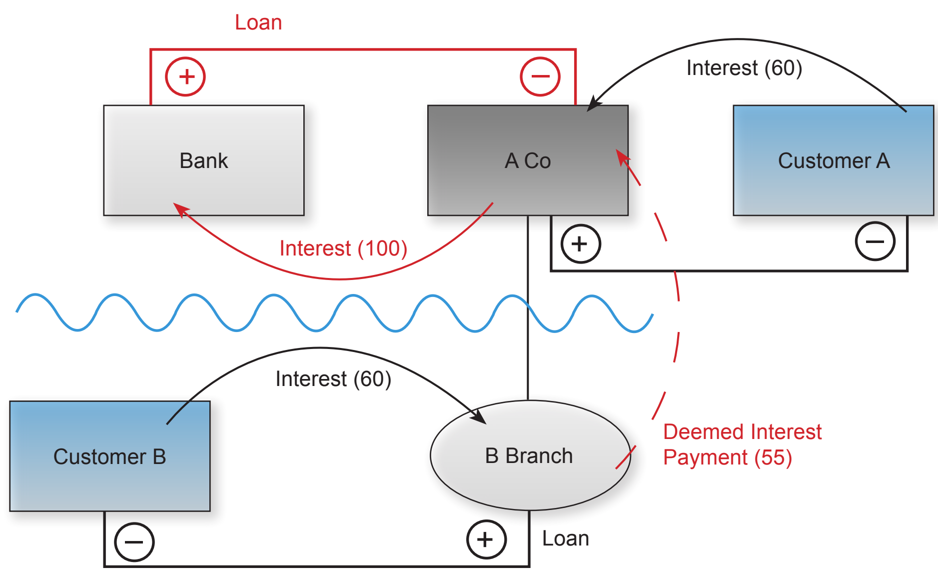
6 Dual inclusion means that income is recognized in both the branch in Country B and the head office in Country A.

7 In the example, the services income is included in the income of the branch, but neither the income nor the royalty is included by the head office.

be treated as outside the scope of the deemed branch payment rule. The example given is an allocation of third party-interest expense of the head office in Country A to its branch in Country B.

In the example, A Co is a company established and resident in Country A. A Co borrows money from an unrelated bank and on-lends half of the borrowed funds to Customer A, a customer located in Country A. A Co lends the remaining portion of the funds to Customer B, a customer located in Country B. The transaction is carried out through B Branch, located in Country B. Country B law calculates the net income of B Branch as if it was a separate entity for tax purposes. In making this calculation Country B treats B Branch as making an interest payment to the head office. This is illustrated as follows:

Figure 4



Under the laws of Country B, the payment is treated as a notional payment. However, the payment is calculated by reference to a certain percentage of A Co's external borrowing costs. Accordingly, the interest expense claimed under Country B law should not be treated as a deemed payment for the purposes of the deemed branch payments rule, as it represents an allocation by the taxpayer of third-party interest costs to the branch. Similarly, a deemed interest payment between the branch and the head office should not be subject to adjustment under this rule to the extent the payment made by B Branch corresponds to an actual allocation of third-party interest expense by the head office under Country A law.

Observation

Different profit attribution methods and expense allocation methods may lead to an actual mismatch. In those instances, an adjustment should be required. Otherwise, no adjustment is required. Unlike hybrid mismatch arrangements where the distinction between disregarded and deductible hybrid payments is based on the legal form of the arrangements, the distinction between the deemed and DD branch payment rules, discussed below, turns on the accounting and tax treatment adopted by the branch and the head office, and the transfer pricing adjustments that are used for arriving at an accurate assessment of the net income in each jurisdiction. Given that these calculations and adjustments are made by the same taxpayer, there does not appear to be any immediate difficulty in determining whether the DD or deemed branch payment rule should be applied, and either rule will be sufficient to neutralize the mismatch.

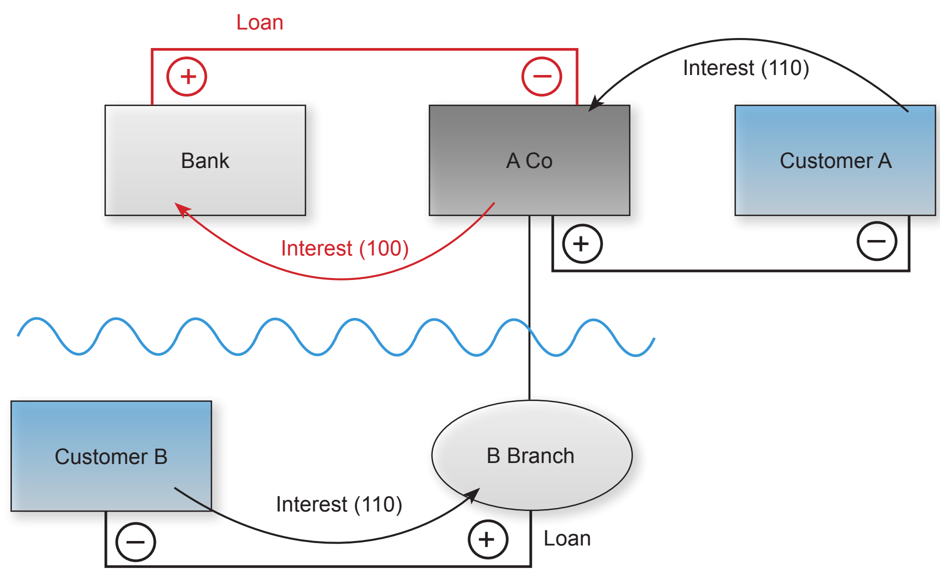
DD BRANCH PAYMENTS

According to the Action 2 Report the O.E.C.D. recommendations on DD outcomes may extend to branch structures. To clarify whether branch arrangements are "hybrid" the Discussion Draft includes examples illustrating scenarios that are deemed to fall within the scope of the Action 2 Report.

"The distinction between the deemed and DD branch payment rules . . . turns on the accounting and tax treatment adopted by the branch and the head office, and the transfer pricing adjustments that are used."

A DD branch payment occurs where the rules for allocating income and expense between a branch and the head office allow a deduction in both the Branch Jurisdiction and the Residence Jurisdiction for the same expense without an inclusion of income. For example, A Co is a company established and resident in Country A, and it has lent money to Customer A, located in Country A. A Co borrows additional funds from a bank and uses those funds to make a loan to Customer B, a customer located in Country B, through B Branch, a branch established in that country. Income attributable to B Branch is exempt or excluded from Country A taxation under Country A domestic law or under a tax treaty between Country A and Country B. This is illustrated by the following:

Figure 5



In this case, the domestic rules governing allocation of interest expense can result in a DD outcome where Country A applies a fungibility approach to the deduction of interest expense while the domestic law of Country B allows the branch to apply a tracing approach. The fungibility approach used in Country A allows for half the amount of the interest expense incurred on the borrowing used to fund the loan to Customer B to offset a portion of the interest income derived from Customer A. At the same time, the entire amount of the interest expense incurred on the borrowing to fund the loan to Customer B is deductible under Country B law to offset the interest income derived from Customer B.

O.E.C.D. Recommendations

The Discussion Draft provides that the Residence Jurisdiction should apply the primary response. Country A should deny A Co's duplicate deductions to the extent they give rise to a mismatch in tax outcomes. The head office would be entitled to carry the denied interest deduction forward in accordance with its ordinary domestic rules and this deduction would be available to offset future dual inclusion income. In the event Country A does not apply the primary response, Country B should deny B Branch a deduction for the payment, to the extent necessary to prevent that deduction from being used to offset income that is not dual inclusion income.

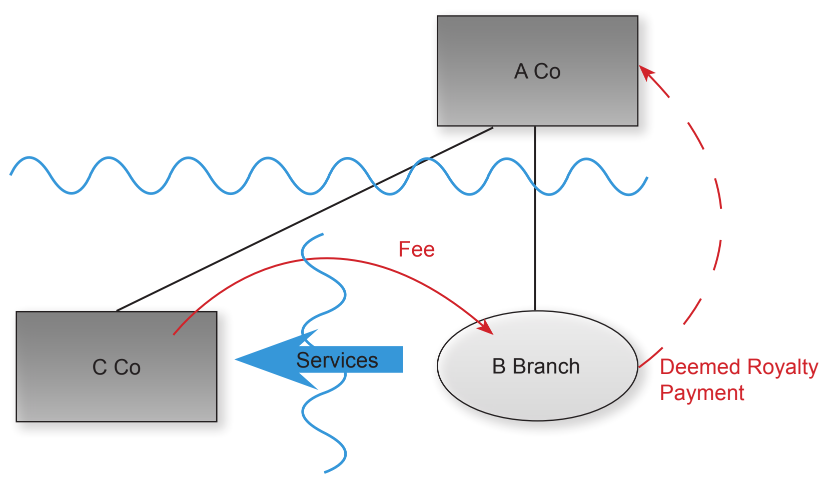
Observation

The recommendation assumes that both A Co and B Branch are fully profitable. The discussion draft does not address circumstances in which B Branch has a net operating loss carryover that eliminates taxable income without taking into account the interest expense incurred by A Co and deducted by B Branch. Should Country A apply the primary response in these circumstances, or should it defer application of the rule until B Branch becomes profitable for income tax purposes? If Country A imposes the rule immediately, branch losses may potentially become stranded. Alternatively, if A Co operates at a loss, can it take advantage of the rule to establish a loan that will not produce full deductions in order to immediately access an expiring net operating loss?

IMPORTED BRANCH MISMATCHES

An imported branch mismatch arises when a taxpayer uses a deduction in a branch mismatch to offset a payment received by a third party. The fact pattern described above regarding deemed branch payments is used to illustrate the mismatch. Thus, B Branch uses I.P. owned by A Co in providing services to C Co. C Co is a subsidiary of A Co. In the example, C Co pays a deductible service fee A Branch C Co. The fee is exempt from tax under Country A law. In Country B, B Branch offsets the fee with a deemed royalty payment that is deductible. Neither Country A nor Country B has adopted a rule addressing the mismatch in tax outcomes arising from the notional payment. The fact pattern is as follows:

Figure 6



O.E.C.D. Recommendations

To neutralize the imported branch mismatch, the O.E.C.D. recommends using the same solutions it described in the Action 2 Report.[8] The treatment of imported mismatches should be the same whether they arise through the use of a branch or a hybrid mismatch structure. In addition, the imported branch mismatch rule applies only to payments made under a structured arrangement or between members of the same group.

Observation

Rules to take care of imported branch mismatches will likely be complex and could result in a territory's right to impose tax on profits that, under common source rules, would be allocated elsewhere. An opt-out similar to reservations to the O.E.C.D. Model Convention may be a solution.[9]

"Rules to take care of imported branch mismatches will likely be complex and could result in a territory's right to impose tax on profits that, under common source rules, would be allocated elsewhere."

CONCLUSION

While the recommendations provide some clarification on the treatment of branch income that results in mismatches, they will undoubtedly lead to complex problems in terms of their application. In addition to inconsistencies with domestic tax principles, domestically drafted legislation may be too narrow or too broad, leading either to additional litigation in the former the case or double taxation in the latter. Taxpayers should seek involvement, directly or indirectly, in the O.E.C.D. discussion process, even if the deadline for comments has passed. Comments on the Discussion Draft[10] will be addressed in the next edition of *Insights*.

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8 Ruchelman, "O.E.C.D. Discussion Drafts Issued Regarding B.E.P.S. Action 2."

9 An opting-out provision was, for instance, suggested for the O.E.C.D.'s Action 15 report on the development of a multilateral instrument to implement tax treaty revisions related B.E.P.S.; also, Robert Stack, the U.S. Department of Treasury's deputy assistant secretary for international tax affairs, indicated earlier this year that the U.S. may opt-out of the O.E.C.D.'s new standards for P.E.'s as outlined in the B.E.P.S. Action 7 report.

10 See comments received by the O.E.C.D., published on September 23, 2016 and available at http://www.oecd.org/ctp/aggressive/Comments-Discussion-draft-branch-Mismatch-Structures.pdf.

TREASURY ATTACKS EUROPEAN COMMISSION ON STATE AID – WHAT NEXT?

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Tags
European Commission
I.R.S.
State Aid
T.F.E.U.
Transfer Pricing

On August 30, 2016, the European Commission ("the Commission") ordered Ireland to claw back €13 billion ($14.5 billion) plus interest from Apple after favorable Irish tax rulings were deemed to be illegal State Aid by the Commission. Not only did the Commission issue this decision, but at the same time, it invited other nations to consider whether profits that flowed through Apple's nonresident Irish branch should instead be taxed in their respective jurisdictions.[1]

This interpretation was shared by O.E.C.D. Secretary-General Angel Gurria,[2] and France may follow suit. In a statement on September 9, 2016, French Finance Minister Michel Sapin called the decision against Apple "completely legitimate," but left it open as to whether France would assess back tax on the company.[3]

The offices of Google and McDonald's in France were raided by French authorities in May of this year. In Italy, Apple paid €318 million in a settlement of a ruling by the Italian tax authorities that the company had improperly booked €880 million in profits to an Irish subsidiary from 2008 to 2013. Apple is also believed to be the subject of investigations by Spanish tax authorities.[4]

European Tax Commissioner Pierre Moscovici defended the European Union's Apple ruling as neither "anti-U.S." nor "arbitrary." Upon his arrival in Slovakia for the Economic and Financial Affairs Council ("E.C.O.F.I.N.") meeting at the beginning of September, the commissioner told reporters that the ruling "is based on facts and data which apply to all companies wherever they come from, and especially from European Union countries." On another occasion, Competition Commissioner Vestager pointed out that BP Plc was forced to pay additional taxes, but was reluctant to comment on the investigation into IKEA.[5] Wherever one's the stance on

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1 In particular, two comments by E.U. Competition Commissioner Margrethe Vestager were noted: The first was that "the money belongs to Ireland," and the second was that "anybody who thinks they have a claim, bring the claim forward and tell us why you think you have a claim."

2 Secretary-General Gurria made the comment in response to a question posed during a September 10 news conference held at the conclusion of a two-day meeting of European Union finance ministers in Bratislava.

3 Notably, France has already had internet multinationals on its radar. In 2013, Amazon revealed that it was contesting a French assessment of $252 million in back taxes. In May of this year, the Paris offices of Google were raided by French officials in the course of a probe into whether Google's Irish unit has a permanent establishment in France.

4 Neither Apple nor representatives of the Spanish tax authorities confirmed the existence of a Spanish investigation.

5 Investigations were initiated by the Swedish Green Party, which provided information to the European Commission.

the U.S.-European debate, it is indisputable that, with limited exception,[6] the most recent tax-related State Aid cases ruled upon by the Commission have focused exclusively on U.S. multinationals' European operations.

THE APPLE CASE: BACKGROUND AND FURTHER DEVELOPMENTS

On June 11, 2014, the European Commission initiated an investigation into advance pricing arrangements provided by the Irish tax authorities to Apple, regarding the attribution of profits to an Irish branch of an Irish company that, under Irish law, was treated as nonresident. The company was not managed and controlled in Ireland. According to the E.U., Apple Sales International allocated the vast majority of its profits to a "head office" that, in the European Commission's opinion, was an entity without economic substance. Apple's tax plan reduced its taxable income considerably. The European Commission's view was that these Irish arrangements with Apple constituted State Aid.

"In an unprecedented procedure, the U.S. Treasury Department released a white paper shortly before the European Commission's Apple decision was issued."

Both Apple and Ireland[7] confirmed that they will appeal the European Commission's decision. It may take years until the case is settled and may ultimately be decided by the European Court of Justice ("E.C.J."). Interestingly, the E.C.J. can merit the Commission's decision or reject it in its entirety, but it cannot revise the amount of the claw-back. It should also be noted that an appeal does not affect the obligation to pay the claw-back amount stipulated in the Commission's decision.[8] To date, the European Commission has initiated State Aid investigations against Apple, Amazon, Starbucks, and Fiat (now Fiat Chrysler Automobiles). Appeals against the Commission's decisions in the Starbucks and Fiat cases are already pending at the European General Court.[9] The Commission has not yet reached a final decision in the Amazon case.

As has been previously noted, the fairness of the European Commission's examination of U.S. multinationals has been questioned. Robert Stack, Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury Department, believes that American companies are being unfairly targeted in the investigations.

In an unprecedented procedure, the U.S. Treasury Department released a white paper[10] ("White Paper") shortly before the European Commission's Apple decision was issued. It expressed profound concern with the European Commission's

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6 One case was directed at the Belgian excess profit scheme and not at a particular company. Another case is being pursued against French utility company Engie SA, formerly GDF Suez.

7 On September 7, 2016, Irish Finance Minister Michael Noonan issued a statement to the House of Representatives (*Dáil Éireann*), seeking support to appeal the European Commission's decision that tax rulings issued by Ireland to Apple in 1991 and 2007 constituted illegal State Aid. On the same date, the Irish Department of Finance issued an explanatory memorandum for Parliament detailing House support of the Irish government's plans to appeal the decision.

8 The amount may be held in escrow until the final decision.

9 Prior to the Lisbon Treaty becoming effective on December 9, 2009, known as Court of First Instance.

10 U.S. Department of the Treasury, "The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings," August 24, 2016.

investigations. The White Paper focused on three points:

- The investigations departed from prior E.U. case law and decisions.
- Retroactive recoveries through the investigation process is inappropriate.
- The European Commission's approach is inconsistent with O.E.C.D. transfer pricing guidelines.

The U.S. Treasury Department believes that the European Commission's investigations undermine the development of transfer pricing norms, the B.E.P.S. Project, and the ability of countries to honor their bilateral tax treaties with the U.S. It additionally notes that any repayment ordered by the European Commission will be entitled to a foreign tax credit in the U.S., thereby reducing U.S. tax liability and effectively transferring tax revenue from the U.S. to the E.U. Finally, the U.S. Treasury Department believes that the investigations will freeze cross-border investment between the E.U. and the U.S. and that retroactive penalties will hinder the ability for companies to plan for the future.

TREASURY'S ANALYSIS OF STATE AID AND THE EUROPEAN COMMISSION INVESTIGATIONS

State Aid exists when a national measure is financed by the state or through state resources in a way that (i) provides an advantage for a business undertaking, (ii) is selective in its application, and (iii) as a result, affects trade between member states by distorting competition.[11] The White Paper focuses primarily on the selectivity and business advantage elements of the definition.

"Advantage" was defined in prior case law to mean "any economic benefit which an undertaking could not have obtained under normal market conditions." For an advantage to be found, it had to be granted in a "selective way to certain undertakings of categories or to certain economic sectors."[12] According to the White Paper, once an advantage has been found, an analysis must be performed to determine whether the advantage is "selective." To be selective, a measure must provide a benefit to certain undertakings in comparison with other comparable undertakings.[13]

The White Paper concludes that prior European Commission rulings stated that measures available to companies with foreign affiliates but not available to domestic companies without foreign affiliates did not constitute "selective measures." Based on these prior rulings, a U.S. multinational would reasonably assume that a transfer pricing ruling granted in good faith by an E.U. Member State would not constitute a "selective measure" simply because a multinational has foreign affiliates whereas a

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11 *Air Liquide Industries Belgium SA v. Ville de Seraing a.o.*, Joined Cases C-393/04 & C-41/05, ECLI:EU:C:2006:403, ¶28. See also "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," *Insights* 6 (2015).

12 Commission Notice on the notion of state aid as referred to in Article 107(1) of the TFEU, 2016 O.J. C 262/1, ¶¶5, 66 and 117.

13 *Portugal v. Commission*, Case C-88/03, ECLI:EU:C:2006:511, ¶54 (citing, among others, *Adria-Wien Pipeline*, Case C-143/99, ECLI:EU:C:2001:598, ¶41).

standalone European company has no affiliates.[14]

The White Paper notes that the European Commission previously separated its advantage analysis from its selective analysis in 65 prior cases. Now, however, in cases involving U.S.-based multinationals, the European Commission has merged the concepts of advantage and selectivity to conclude that a transfer pricing ruling is a selective advantage for a company that is part of a multinational group. According to the U.S. Treasury, the European Commission expanded protection of local companies because "selectivity" was often the largest barrier to finding the existence of a State Aid violation.

Observation

On this point, the U.S. Treasury Department is in line with the applicants in their appeal against the Commission's decisions in Starbucks and Fiat, focusing on the Commission's assessment of the two key State Aid conditions, *i.e.* advantage and selectivity. The Commission's new approach of collapsing the advantage and selectivity requirements has important substantive significance. Now, the Commission can find advantage if it disagrees with the Member State's application of the arm's length principle to a particular set of facts that are often highly complicated. The Commission's new approach reduces a State Aid inquiry to the question of whether the Commission believes that a transfer pricing ruling satisfies its view of the arm's length principle.[15]

RETROACTIVE RECOVERY

For a violation of State Aid regulations, the European Commission may require recovery for up to 10 years, with interest accruing for the period that the illegal aid was granted until the aid is recovered. According to the White Paper, U.S. multinational groups could not have foreseen the European Commission's new approach. Consequently, the recovery amount is a retroactive penalty.

In effect, because the transfer pricing was held to be valid in certain countries and due to the fact that the European Commission had tacitly accepted such arrangements for a long period, multinationals could not know that they would be considered to be infringing E.U. law. The U.S. Treasury Department notes that such a retroactive penalty is a fundamental violation of the principles stated by the G-20, the E.U., and the B.E.P.S. Project, which provide certainty to taxpayers while respecting each country's domestic transfer pricing agreements.

Finally, while the European Commission rulings make reference to an "arm's length principle," the U.S. Treasury Department notes that such a term remains undefined in the rulings. The White Paper implies what most U.S. tax advisers believe: that the

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14 Treatment by the Netherlands tax authorities of a technolease agreement between Philips and Rabobank, Commission Decision 2000/735/EC, 2000 O.J. L 297/13, ¶36

15 In a summary of its claims, Fiat stated:

> The contested decision breaches the principle of legal certainty since the commission's novel formulation of the arm's length principle introduces complete uncertainty and confusion as to when an advance pricing agreement, and indeed any transfer pricing analysis, might breach EU state aid rules.

investigations are politically motivated to punish E.U. countries with low tax rates or favorable practices, and multinationals that plan structures using those jurisdictions.

Observation

The introduction of a new arm's length standard by the European Commission has been previously noted in *Insights*.[16] The U.S. is joined in this assessment by Fiat and the Netherlands. In their appeals, Fiat touched the heart of the matter when it accused the Commission of failing to show how it derived the arm's length principle from Union law, or even what the principle is. These are harsh words, and a similar argument was put forward by the Netherlands in an even more unequivocal manner, when it was argued that there is no arm's length principle in E.U. law and that that principle is not part of a State Aid assessment.

In addition, the claw-back of taxes poses the following question: who is bearing the cost? Eventually, it will be the U.S. taxpayer, due to the foreign tax credit system in effect in the U.S. Under the U.S. tax system, foreign income taxes imposed on foreign subsidiaries of U.S. companies may be credited by their U.S. parent company when dividends are paid.[17] Within the limitations of U.S. tax law,[18] the credit reduces U.S. tax imposed on foreign-source income.

Some believe that the State Aid cases brought by the European Commission will invite a transatlantic trade war, which is of concern to the U.S. Treasury Department. In the White Paper, the following comment was made:[19]

> A strongly preferred and mutually beneficial outcome would be a return to the system of international tax cooperation that has long fostered cross border investment between the United States and EU Member States. The U.S. Treasury Department remains ready and willing to look for a path forward that achieves the shared objective of preventing the continued erosion of the corporate tax base while ensuring our international tax system is fair for all.

A similar statement was made by a spokesman for the U.S. Treasury Department:

> The Commission's actions could threaten to undermine foreign investment, the business climate in Europe, and the important spirit of economic partnership between the U.S. and the EU. We will continue to monitor these cases as they progress, and we will continue to work with the Commission toward our shared objective of preventing the erosion of our corporate tax bases.

In an article published in the *Wall Street Journal* on September 13, 2016, Treasury Secretary Jack Lew called for a U.S. tax reform in view of "Europe's Bite Out of Apple."

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16 Beate Erwin and Christine Long, "E.U. State Aid – The Saga Continues," *Insights* 6 (2016).

17 In addition, a credit may apply when a U.S. shareholder of a controlled foreign corporation includes in income an item of Subpart F income. Code §960.

18 Primarily, Code §904.

19 U.S. Department of the Treasury, "Treasury Releases White Paper on European Commission's State Aid Investigations into Transfer Pricing Rulings," accessed September 26, 2016..

CONCLUSION

The U.S. Treasury Department notes that the European Commission's interference in Member States' tax authority effectively undermines relations among those countries and with the U.S. More importantly, if domestic decisions can be overridden using a European Commission ruling, an E.U. Member State's power to enter into a bilateral income tax treaty is ultimately dismantled. On a practical level, U.S. multinational groups will have no interest in obtaining advance pricing agreements with an E.U. Member State which makes all pricing arrangements subject to audit in the U.S. and Europe.

The decision of the General Court in the State Aid cases will have far-reaching consequences. Should the court reject one of the Commission's main arguments, most notably its assertion that a deviation from the Commission's interpretation of the arm's length principle confers a "selective advantage" on the recipient, then it is likely that all of its final decisions will be annulled, since they are based on the same doctrinal "pillars." Moreover, if the E.C.J. does not support the Commission's approach on appeal, the Commission's use of the State Aid mechanism to crack down on tax avoidance will have failed dramatically. However, it will take years before certainty is reached on this level.

"Should the court reject one of the Commission's main arguments . . . it is likely that all of its final decisions will be annulled, since they are based on the same doctrinal 'pillars.'"

Until then, it remains to be seen whether pressure by the U.S. tax authorities will restrain the European Commission, or whether the European Commission will expand its investigations to include other U.S. multinationals. At this stage, with both the U.S. and the European Commission adamant in their respective positions, the stage is set for a prolonged battle. Meanwhile, U.S. multinationals are faced with difficult decisions on pricing and must carefully consider their European strategies.

CORPORATE MATTERS:

INITIAL STEPS IN SELLING A PRIVATELY HELD CORPORATION

Author
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Tags
Corporate Law
Due Diligence
Sale

The owner of a corporation can decide at any time to sell his or her business. There are many reasons why an owner may want to sell – including retirement, a general desire to cash out, and fatigue. Further, if the business has multiple owners, some owners may want out and have a drag-along right or, upon hearing that some owners want to sell and their reasons for selling, the other owners may decide it is a good time for them to sell, also. Once the decision has been made – what happens next?

The owners can decide among themselves when to sell, how much to sell for, and the terms of the sale. It may be that there are many potential purchasers, or there could be just one. In any event, any purchaser will want to find out as much as they can about the company before any commitment with respect to a purchase is made.

In determining how much information to provide, a seller usually thinks along the lines of "as little information as possible to keep the buyer interested." Most sellers are naturally hesitant about providing commercially sensitive information about their company until they are certain the transaction is going to close. On the other side of that equation is a buyer who wants to know everything they can about the target company before proceeding. Initially, it is not a bad idea for a seller to provide basic information – enough to keep potential buyers interested until it can be determined which of them is likely to complete the purchase.

The principal questions a seller should ask are, "How confidential is the information?" and "How can it be used against me?" The answers to these questions will determine the scope and nature of the information to be initially provided to a buyer.[1]

Once the initial information is supplied and the potential buyer has become genuinely interested, the seller should expect to receive a full-blown due diligence request list. While the seller may still be hesitant to provide information, at this point in the transaction it is likely that a buyer will not proceed unless the documents requested in the due diligence request list are provided. In some instances, the seller's reluctance may not be warranted – in less competitive industries, specific information can be provided without jeopardizing the business. In those industries where a seller's business may be adversely affected by the dissemination of the information, the utilization of a nondisclosure agreement can lessen the impact of any adverse effects stemming from disclosure.[2]

A nondisclosure agreement seeks to limit the use of the information provided to the analysis required to enable the buyer to make a decision regarding whether or not to buy, and prohibits the reproduction or distribution of the information for any

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1 Silton, Lawrence C. *How to Buy or Sell the Closely Held Corporation*. Englewood Cliffs, NJ: Prentice-Hall, 1987.

2 *Id.*

other purpose. The seller can stipulate the level of confidentiality required and also specify exactly what information is confidential. In practice, information is often provided by way of an electronic data room, and the seller can also seek to limit the individuals that have access to the room.

Often included in a nondisclosure agreement is an exclusivity clause, because, from a buyer's point of view, with genuine interest comes genuine cost. A buyer may have employed a team of accountants and lawyers to review the financial and legal documentation, and they would not want the deal to continue to be "shopped" during this stage. The exclusivity clause contained in the nondisclosure agreement would provide assurance that for a certain time period, the seller will not, and will not permit any of its representatives to, directly or indirectly solicit or encourage the initiation of any expression of interest from any person relating to a possible business transaction along the lines of the one currently being pursued by the buyer. An exclusivity clause would also prohibit the seller from participating in any discussions with, or providing any non-public information to, any person in connection with such a business transaction.

"The bottom line is that they [the owners] also have a business they are trying to sell. In order for them to continue running their business . . . the seller must rely on its professional advisors."

Once the nondisclosure agreement has been entered into, the seller can expect to receive a due diligence request list covering matters such as the following:

- General corporate documentation
- Capitalization
- Personnel
- Customer and supplier documentation
- General financial and tax information
- Properties
- Intellectual property
- Environmental matters
- Litigation
- Regulatory matters
- Consents
- General business information

It cannot be stressed enough that at this stage the seller should have already assembled its "team." At a minimum, a lawyer and an accountant will be required for a transaction of any size. Moving ahead without the proper advisors, even at this early stage, may limit the chances of a successful transaction and frustrate a buyer who has assembled a team. In transactions involving a middle market company, it is common to hear from sellers that they are frustrated with the level of due diligence and that they "have a business to run." The bottom line is that they also have a business they are trying to sell. In order for them to continue running their business, either to ensure its continued profitability in the event the transaction does not close or to keep potential buyer(s) interested with ongoing solid results, the seller must rely on its professional advisors.

UPROAR OVER PROPOSED §385 REGULATIONS: WILL TREASURY DELAY ADOPTION?

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Tags
Code §163(j)
Code §385
Code §482
Code §7874
Earnings Stripping
Interest Deductions
Related-Party Debt

OVERVIEW

On April 4, the U.S. Treasury Department issued comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity.[1] While the initial motivation for the Treasury action was an attempt to deter inversions by American companies, the proposed regulations have a far greater impact. They affect companies with no intent to create an inversion and U.S. companies having shareholders that are all U.S.-based and operated. This was discussed in an earlier article in *Insights*.[2]

As noted in *Insights*, senior Treasury Department officials have indicated that these proposed regulations are a high priority item for the government. While these officials have indicated that they are open to some modifications based on comments they have received, their primary goal is to finalize all or a major part of the regulations later this year. On July 14, about 15 business representatives lined up to speak at an I.R.S. hearing on the proposed regulations. While the speakers advanced a number of compelling arguments in favor of modifying the tax regulations, I.R.S. and Treasury officials remained mostly silent regarding their plans for the regulations.[3]

In an unprecedented reaction outside the public hearing, the proposed regulations have received widespread criticism from members of Congress, the business community, bar and accounting groups, and practitioners. The comments generally fall into two groups. One raises technical issues and the other raises policy issues. Comments in the former group focus on the unintended impact of the regulations on routine business transactions. These commentators call for more time to revise the regulations in order to address the technical problems in a more detailed manner, which cannot be completed by the end of the year. Comments in the latter group focus on the potential harm that could be inflicted on the business community under the proposals as currently drafted. Several commentators, including the leaders of the two tax-writing committees in Congress, asked for a complete withdrawal of the regulations and a more comprehensive review of all pertinent issues. These commentators also call for additional study, but do so with the goal of defining the boundaries of the proposed regulations.

The Treasury has been listening, and indicated in some public forums that they are considering changes. The rules regarding cash pooling arrangements within a

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1 Prop. Treas. Reg. §§1.385-1, -2, -3, and -4.

2 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights*, Vol. 3, No. 5 (May 2016).

3 S. Olchyk and A. Norman, "Business Reps Urge Overhaul of US Debt/Equity Proposed Regulations at Hearing," *MNE Tax* (July 15, 2016)..

multinational group, foreign-to-foreign loans within a group, and the so-called "current year's earnings" rule are likely to be reworked. In addition, changes are under consideration for the documentation requirements of the proposals. However, the Treasury has not retreated from its initial goal of having a significant portion of the regulations finalized this year. The Treasury has not yet announced that it would delay adoption, but also has not indicated a specific target date for final adoption.

EXECUTIVE SUMMARY OF THE PROPOSED REGULATIONS

The proposed regulations under Code §385[4] will have a major impact on *any* tax planning involving related-party debt by potentially re-characterizing such debt as equity under three new rules:[5]

- First, a debt re-characterization rule provides that debt instruments are treated as stock if issued in certain disfavored transactions (such as when debt is distributed as a dividend to a shareholder).[6]
- Second, contemporaneous documentation requirements are imposed as a condition to retain the treatment of related-party debt as true debt (and not equity) for tax purposes.[7]
- Third, a bifurcation rule allows the I.R.S. to re-characterize certain related-party debt as part debt and part equity.[8]

Debt Re-characterization Rule

The debt re-characterization rule will reclassify as equity debt issued between members of a related party group called an expanded group ("E.G.") if issued in any of the following three fact patterns ("Targeted Transactions"):

- A debt instrument is distributed by an E.G. member to a shareholder who is part of that E.G. (*e.g.*, a dividend or return of capital distribution in the form of notes).
- A debt instrument is transferred in exchange for stock of another E.G. member (*e.g.*, a member of an E.G. acquires stock of another member in exchange for issuing a note to the selling member), other than in an exempt exchange.
- A debt instrument is transferred in exchange for property of another E.G. member in the context of certain tax-free asset reorganizations, but only to the extent that, pursuant to a plan, a shareholder that is a member of the E.G.

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4 References to a code section designate a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

5 Prop. Treas. Reg. §§1.385-1, 2, 3, & 4.

6 Prop. Treas. Reg. §1.385-3.

7 Prop. Treas. Reg. §1,385-2. In general, the documentation must be prepared no later than 30 calendar days after the date that the instrument becomes a related-party debt instrument.

8 Prop. Treas. Reg. §1.385-1(d).

before the reorganization receives the debt instrument.[9]

The regulations adopt an anti-abuse rule called the "funding rule" in order to combat cases where companies may engage in two transactions that together have the same impact as a one-step direct issuance of debt in a Targeted Transaction. For example, a company may want to issue a debt instrument as a dividend to its sole shareholder, but that type of transaction is a Targeted Transaction. The company and its sole shareholder may attempt to circumvent the Targeted Transaction by having the shareholder lend funds to the company after which the company distributes a dividend to the shareholder in the same amount in a pre-arranged transaction. Before the loan, the shareholder held cash and after the dividend, the shareholder held the same amount of cash and a note of the subsidiary. If the roundtrip of the cash is ignored, the only transaction left is the creation of a note distributed to the shareholder. When integrated, this two-step transaction produces the same result as a simple distribution of a note.

The funding rule in the proposed regulations addresses two-step transactions by re-characterizing the debt as equity. Under the funding rule, debt is subject to re-characterization as equity if it is a "principal purpose debt instrument."[10] A principal purpose debt instrument is a debt instrument issued by "the funded member" with a principal purpose of funding one of the following distributions or acquisitions ("Targeted Funding Transactions"):

- A distribution of cash or property by the funded member to another E.G. member
- An acquisition by the funded member of stock of another E.G. member for cash or property, other than in an exempt exchange (as defined above)
- An acquisition by the funded member of assets of another E.G. member in an asset reorganization, but only to the extent that, pursuant to the plan, a shareholder in the funded member that is, itself, a member of the E.G., receives cash or "other property"[11] with respect to its stock in the transferor corporation.[12] To illustrate, the common parent of acquirer and transferor lends funds to acquirer that is used as part of the consideration to acquire the assets of transferor in a reorganization involving stock and boot. The integrated transaction concludes with a distribution of the stock and boot to the common parent.

The principal purpose of the debt issuance is determined based on facts and circumstances.[13] However, the funding rule contains a "non-rebuttable" presumption that an instrument is a principal purpose debt instrument if the debt is issued at any time during the 72-month period beginning 36 months before and ending 36 months

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9 Prop. Treas. Reg. §1.385-3(b)(2). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

10 Prop. Treas. Reg. §1.385-3(b)(3)(i). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

11 In other words, "boot" within the meaning of Code §356.

12 Prop. Treas. Reg. §1.385-3(b)(3)(ii).

13 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(A).

after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction.[14] For example, if a foreign parent corporation lends $1,000 to its wholly-owned subsidiary in the U.S., and 30 months later, the U.S. subsidiary distributes $1,000 cash back to the foreign parent, but not as part of a pre-arranged plan, the non-rebuttable presumption applies and the debt instrument is characterized as equity.

Interestingly, the I.R.S. justifies the non-rebuttable presumption because it has encountered difficulty in proving loans and dividend distributions are connected. To that end, the preamble to the regulations provides the following justification:

> The Treasury Department and the IRS have determined that this non-rebuttable presumption is appropriate because money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions. In the absence of a *per se* rule, taxpayers could assert that free cash flow generated from operations funded any distributions and acquisitions, while any debt instrument was incurred to finance the capital needs of those operations. Because taxpayers would be able to document the purposes of funding transactions accordingly, it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition.[15]

The non-rebuttable presumption has been identified as one of the biggest problems of the debt characterization rule because of the length of the period and the inability of taxpayers to demonstrate the absence of tax avoidance.

Documentation Rules

There are four parts to the documentation rules that impose a new set of requirements in order to support true debt status for U.S. tax purposes.

The first requirement is there must be a binding obligation to repay the funds advanced. This rule requires evidence in the form of a timely-prepared written document executed by the parties.[16] The preamble explains the reason for this requirement:

> The proposed regulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties. This requirement also serves to help demonstrate whether there was intent to create a true debtor-creditor relationship that results in *bona fide* indebtedness and also to help ensure that the documentation necessary to perform an analysis of a purported debt instrument is prepared and maintained. This approach is consistent with the long-standing view held by courts that the taxpayer has the burden of substantiating its

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14 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

15 Preamble to Prop Regs. 04/08/2016. Fed. Reg. Vol. 81, No. 68, p. 20911, [REG-108060-15] ("Preamble") Explanation §IV.B.2.b.i.

16 Prop. Treas. Reg. §1.385-2(b)(2)(i).

treatment of an arrangement as indebtedness for federal tax purposes. *Hollenbeck v. Commissioner*, 422 F.2d 2, 4 (9th Cir. 1970).[17]

The second requirement is for the loan documentation to delineate the creditor's rights to enforce the debtor's obligation to repay.[18] Typical creditor rights include the right to trigger a default, the right to accelerate payments, and the superior right over shareholders to share in the assets of the issuer in the event that the issuer is dissolved or liquidated.

"There are four parts to the documentation rules that impose a new set of requirements in order to support true debt status for U.S. tax purposes."

The third requirement is a reasonable expectation of repayment by the issuer of the loan.[19] This rule requires that the taxpayer prepare and maintain supporting documentation such as cash flow projections, financial statements, business forecasts, asset appraisals, and the determination of debt to-equity and other relevant financial ratios of the issuer. For those advising multinational groups on the documentation required to support an intercompany debt as true debt, this is not a new requirement. The I.R.S. has routinely examined the credit-worthiness of U.S. borrowers in determining whether interest expense is deductible. Credit-worthiness is determined under an objective standard. When a disregarded entity having limited liability, such as a wholly-owned U.S. L.L.C., is the borrower, credit-worthiness is based on the assets of the disregarded entity.

The final requirement is evidence of a genuine debtor-creditor relationship.[20] This means that payment of interest and principal is made when and as provided in the loan documentation and such payment must be demonstrated. Examples of proof of payment include wire transfer records and account statements.

Bifurcation Rule

The proposed regulations give the I.R.S. the power to split a single debt instrument into part equity and part debt. A major problem with this new rule is there are few guidelines as to when it may apply. Again, advisers to multinational groups that have paid attention to the credit-worthiness issue of a U.S. borrower from a foreign parent have often split lending transactions into two documents with different maturity dates so that a challenge to the status of debt could be limited to one of the lending transactions.

CONGRESSIONAL REACTION

The regulations have been criticized by members of the tax-writing committees of Congress. All Federal tax legislation must originate in the House of Representatives and the House Ways and Means Committee has jurisdiction. In the summer, Ways and Means Committee Chairman Kevin Brady (R.-T.X.) released a statement after meeting with the Treasury Department to discuss the proposed regulations.[21] Congressman Brady expressed strong opposition to the adoption of the regulations

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17 Preamble Background §VI.B.2.

18 Prop. Treas. Reg. §1.385-2(b)(2)(ii).

19 Prop. Treas. Reg. §1.385-2(b)(2)(iii).

20 Prop. Treas. Reg. §1.385-2(b)(2)(iv).

21 "Ways & Means GOP to Treasury: Proposed Regulations Threaten Jobs & Economic Growth." U.S. House of Representatives Ways and Means Committee. June 28, 2016.

in their current form, and called on the Treasury Department to reconsider the approach.

> Ways and Means Republicans…have serious concerns about the economic impact of Treasury's proposed section 385 regulations. Instead of preventing corporate inversion transactions, these regulations will actually discourage U.S. and international companies from investing in America and our workers.
>
> Today we had an opportunity to have a frank discussion with Treasury about the negative consequences of the proposed regulations and about the Administration's response to the American people's extensive comments and concerns about this proposal. The proposed regulations as currently drafted would be a damaging disruption in well-settled law with far-reaching implications for common business financing practices. During our discussion, I made it clear that this is neither the time nor the place for such unilateral action from the Administration.
>
> In the days and months ahead, there must be a robust conversation among the Administration, the tax-writing committees, and affected stakeholders about the next steps in this process. We intend to continue to work with Treasury and the business community to protect American workers and their jobs. Ways and Means Members will consider all legislative options going forward.[22]

The Senate Finance Committee has jurisdiction for tax legislation in the Senate. In the summer, Senate Finance Committee Chairman Orrin Hatch (R-U.T.) wrote to the Treasury department, citing concerns over the policy and regulatory process of the Treasury Department. He called on Treasury Secretary Jack Lew to re-issue the regulations in proposed form.[23]

> I ask you to re-propose the regulations not because I wish for there to not be any section 385 regulations. Rather, I am seeking to ensure that, should the Treasury Department issue regulations under IRC section 385, the Department does so in a thoughtful, prudent, and legal manner.

Senator Hatch commented that the regulations in their current form could lead to unintended consequences for American businesses given the Administration's expedited timeline for issuance in final form. He questioned the regulatory transparency of the proposals, contending that statutory and executive order requirements may not have been followed properly.

> Your consideration of these concerns needs to be done in a thoughtful and deliberate manner. Moving swiftly to finalize the proposed regulations would not be consistent with such an approach. * * * The only prudent way to move forward -- given the complexity of the

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22 "Brady Statement after Discussion with Administration Officials Regarding Section 385 Regulations." U.S. House of Representatives Ways and Means Committee. July 06, 2016.

23 "Hatch Calls on Treasury to Re-Propose Debt-Equity Rules." U.S. Senate Committee on Finance. August 22, 2016.

> subject matter, given the many significant substantive concerns that have been pointed out, and given the procedural irregularities -- is to issue the regulations in re-proposed form.

U.S. Senators Dean Heller (R.-N.V.), Mike Crapo (R.-I.D.), Pat Roberts (R.-K.S.), John Cornyn (R.-T.X.), John Thune (R.-S.D.), Johnny Isakson (R.-G.A.), and Tim Scott (R.-S.C.) sent letters to Jacob Lew, Secretary of the Treasury, regarding the regulations. The letters requested an extension of the public comment period and asked the Treasury to ensure that ordinary business transactions, such as cash pooling, are not caught by the rules or subject to burdensome compliance requirements.[24]

BUSINESS COMMUNITY REACTION

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.[25] The Chamber sent a letter to Treasury Secretary Lew expressing its opposition to the adoption of the regulations in their current form.[26] The Chamber asked that the regulations be withdrawn or, alternatively, suggested numerous changes.

> The Chamber continues to believe that additional time is needed to analyze and review the impact of these rules on both ordinary business operations as well as more extraordinary transactions. The breadth, scope, and consequences of these regulations for Chamber members are vastly greater than ever suggested in prior notices and other guidance. Rather than address base erosion concerns in the context of inversions as suggested in the earlier notices, these regulations impact the use of intercompany debt among all multinational groups, both domestic and foreign, except where those instruments are issued between U.S. consolidated group members. In certain instances, even wholly domestic groups are impacted.[27]

The Business Roundtable is an association of chief executives who lead companies that operate in every sector of the U.S. economy.[28] In a letter dated July 8, 2016 to Secretary Lew,[29] the Roundtable expressed very serious concerns about adoption of the regulations:

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24 "Heller Leads Letter to Treasury Secretary Lew Expressing Concerns Over Proposed 385 Rules." United States Senator Dean Heller. July 5, 2016.; "Letter to the Secretary of the Treasury." Dean Heller, Mike Crapo, Pat Roberts, John Cornyn, John Thune, Johnny Isakson, and Tim Scott to Jacob Lew. August 24, 2016.

25 See U.S. Chamber of Commerce webpage, https://www.uschamber.com/.

26 "Letter on Proposed Treasury Regulations under Section 385." U.S. Chamber of Commerce. May 6, 2016.

27 "Proposed Regulations Under §385 (REG-108060-15)." Caroline L. Harris to Internal Revenue Service. July 6, 2016. In U.S. Chamber of Commerce.

28 See Business Roundtable webpage, http://businessroundtable.org/.

29 "Report: Treasury's Rules Will Cause Serious Economic Harm." Business Roundtable. July 8, 2016.

> Business Roundtable * * * has very serious concerns about the business disruption and consequent harmful impact on the economy that would result from the Proposed Regulations. As drafted, the Proposed Regulations have an extremely broad impact, create significant uncertainty, have adverse consequences completely unrelated and disproportionate to the Treasury Department's stated concerns regarding 'inversion transactions' and 'earnings stripping.' * * * Business Roundtable believes the approach taken in the Proposed Regulations exceeds the regulatory authority granted to Treasury by Congress under Section 385. Further, the Proposed Regulations are inconsistent with fundamental principles of U.S. tax law, prior regulatory guidance, case law precedents, and Congressional intent.

BAR GROUP AND PRACTITIONER REACTION

The American Bar Association Section of Taxation issued a detailed 153-page report on the proposed regulations that raised a multitude of issues, especially in regards to the timetable for adoption of final regulations.[30]

> The Proposed Regulations represent a stark departure from a century of federal income tax law on the treatment of such instruments, and, as a result, we are concerned with the abbreviated comment period being afforded with respect to such sweeping changes. * * * [W]e strongly urge Treasury and the Service to take the time necessary to evaluate and develop these rules, even if that means that the final version of the Proposed Regulations ("Final Regulations") cannot be issued as swiftly as the Treasury would have desired, and even if all or parts of the rules must be reproposed. We note that the April 4, 2016, effective date of Proposed Regulation section 1.385-3 has the effect of deterring targeted transactions pending the adoption of final rules, allowing Treasury and the Service time to study and develop responses to all of the comments that are received.

The New York State Bar Association Section of Taxation issued a detailed 172-page report on the proposed regulations that raised a multitude of issues that need to be addressed.[31] Again, the timetable for adoption was criticized:

> The Proposed Regulations represent a substantial change from settled law, with far-reaching implications, the full breadth of which may not be grasped by taxpayers, or the government, for some time to come. For well-advised taxpayers, the Proposed Regulations in their current form would have significant and disruptive effects on

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30 "Comments on Proposed Regulations under Section 385." George C. Howell, III to John Koskinen, William J. Wilkins, and Mark Mazur. July 13, 2016. In American Bar Association, Section of Taxation.

31 See "Report No. 1351 on Proposed Regulations under Section 385." Stephen B. Land to Mark J. Mazur, John Koskinen, and William J. Wilkins. June 29, 2016. In New York State Bar Association, Tax Section.; see also *Report on Proposed Regulations under Section 385*. Report no. 1351. Tax Section, New York State Bar Association. June 29, 2016.

> "The A.B.A. Section of Taxation issued a detailed 153-page report on the proposed regulations that raised a multitude of issues, especially in regards to the timetable for adoption of final regulations."

> ordinary commercial activities and on other transactions that may not implicate tax policy concerns. For other taxpayers, the Proposed Regulations— and, in particular, Prop. Treas. Reg. § 1.385-3—will often operate as a trap for the unwary, in which taxpayers may learn only after the fact that an intercompany loan with customary debt terms can cause adverse tax consequences, even if the loan would (absent the Proposed Regulations) clearly constitute debt for U.S. federal income tax purposes. The fact that the Proposed Regulations raise these issues may to some extent be unavoidable, since Section 385 appears designed to distinguish between debt and equity based on a variety of factors germane to that analysis, rather than drawing the debt-equity distinction in a manner designed to achieve other tax policy goals.
>
> We recognize the importance of the government's policy objectives in issuing the Proposed Regulations. However, we are concerned that Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both need to be substantially revised in order to operate properly. In addition, we strongly recommend that Prop. Treas. Reg. § 1.385-3 not be issued as a final regulation, due to the deep problems inherent in the proposed rule. We urge that the government instead put forward alternative guidance for taxpayers' and practitioners' review and comment.

Other bar and professional groups have spoken out in opposition to the proposed regulations, including the District of Columbia Bar Association[32] and the American Institute of Certified Public Accountants.[33]

CONCLUSION

While Code §385 directly addresses debt-equity classification issues, this section was dormant for almost 40 years, with only one set of regulations that were issued and immediately withdrawn in 1983.[34] The Treasury decision to resurrect Code §385 as a tool to combat inversions was expected, but the Treasury's decision to expand the scope of the attack to all forms of related-party debt caught nearly everyone by surprise. Major issues and problems have been raised by commentators. However, the most immediate problem is the announced timetable for the adoption of the regulations in final form.

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32 "Comments Regarding the Proposed Regulations on Related-Party Debt Instruments, Prop. Treas. Reg. Sections 1.385-1, -2, -3 and -4." Letter to Mark J. Mazur, John Koskinen, and William J. Wilkins. June 30, 2016.

33 "Proposed Regulations Regarding the Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)." Troy K. Lewis to Jacob Lew, John Koskinen, Mark Mazur, and William Wilkins. July 7, 2016. In American Institute of CPAs.

34 T.D. 7920, 1983-2 C.B. 69.

PROJECTED TAX EXPENSE: CAN IT BE COMPUTED ON THE BACK OF AN ENVELOPE?

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Tags
Alternative Minimum Tax
Puerto Rico
Walmart

BACKGROUND

Before making an investment, a potential investor often asks a tax adviser about the expected U.S. tax on projected profits. This seems like an easy question, but a reliable answer is anything but straightforward when a structure is significantly leveraged, takes into account depreciation determined on the basis of a cost segregation study, and the project generates revenue that may benefit from credits and the domestic production activities deduction. The computation may provide inaccurate results if management simply applies the regular Federal and state tax rates to projected income for financial statement purposes. In such a case, the projection ignores the effect of the alternative minimum tax ("A.M.T."), which may be material. The A.M.T. is a tax that is imposed at a lower rate but on a broader tax base, so that the taxation of corporations will be more in line with their economic income. As a result, projections of tax liability may be grossly underestimated in the absence of a detailed *pro forma* tax return.

The giant U.S. retailer Wal-Mart encountered this type of understatement in Puerto Rico when the local A.M.T. rules were materially changed in 2015. The balance of this article provides a general description of the A.M.T. in the U.S. and the terrible effect the Puerto Rican version had on Wal-Mart in Puerto Rico when the law was changed.

THE ALTERNATIVE MINIMUM TAX

Under Federal tax laws, a corporation must pay the A.M.T. if its "tentative minimum tax" is more than its regular tax. The tentative tax calculation starts with the taxable income and applies significant adjustments. Recognition of income is accelerated, depreciation is slowed by the use of longer cost recovery periods, various items of income that are exempt for the regular tax are added back for A.M.T. purposes, and deductions for items such as dividends received and net operating loss carryovers may be limited. The adjusted taxable income used for the calculation of the tentative liability is increased by a further adjustment based on the corporation's adjusted current earnings. The adjusted current earnings ("A.C.E.") are calculated and 75% of the excess of the A.C.E. over the interim adjusted taxable income is added. After all computations and adjustments are made, a corporation benefits from a $40,000 exemption, and the balance is subject to tax at a flat rate of 20%.

If the tentative tax liability calculated exceeds the regular tax liability, the excess, which is the A.M.T., is added to the regular tax liability. Any A.M.T. reported during a current year may be used as a credit in future years when the regular tax liability is lower than the tentative tax liability. However, the A.M.T. credit can only reduce regular tax liability to the extent of the tentative tax liability, but any excess A.M.T. credit can be carried forward indefinitely. As can be seen, these computations go far beyond applying statutory tax rates to projected book income.

EXCEPTIONS

Small corporations having average annual gross receipts of less than $5 million for the corporation's first three years are exempt from the A.M.T. Following the first three years, A.M.T. exemption is allowed for corporations having average annual gross receipts for the preceding three-year period that does not exceed $7.5 million. For the first year in existence, all corporations are exempt from the A.M.T. regardless of gross receipts for the year.

IN THE NEWS

Wal-Mart Puerto Rico, Inc. v. Juan C. Zaragoza-Gomez[1] illustrates how a short-form tax projection can be problematic.

The case involved the A.M.T. in effect in Puerto Rico. The Commonwealth of Puerto Rico was in dire financial straits. Its public debt was larger than its gross national product and its annual budget was running a structural deficit in excess of $1 billion.

Against this backdrop, the Puerto Rican legislature amended the A.M.T. in an effort to raise more tax revenue. Like the A.M.T. in the U.S., the Puerto Rican A.M.T. is a tax equal to the amount by which a corporate taxpayer's tentative minimum tax exceeds its regular tax on taxable income. Two A.M.T. computations were made, and the one that produced the greater tax was the one that was used. The first computation adjusted the computation of income, much like the rules in the U.S. The second computation contained two components: an expense tax and a tangible property tax. The expense tax was a 20% tax on services provided to the corporate taxpayer by a related party or home office outside of Puerto Rico. The tangible property tax was a tax on the goods sold or transferred to the corporate taxpayer by a related party or home office outside of Puerto Rico. Prior to the 2015 amendment, the tangible property tax was a 2% flat tax. The 2015 amendment provided new graduated rates for the A.M.T.'s tangible property tax, with a top rate of 6.5% for corporate taxpayers with $2.75 billion or more in gross sales in Puerto Rico.

Initially, the purpose of the expenses and tangible property taxes was to prevent multistate corporations doing business in Puerto Rico from shifting profits off the island by purchasing goods and services from related mainland entities at artificially inflated prices. The concern was that by manipulating prices for transactions between related entities, a multistate taxpayer could shift profits to another jurisdiction with a lower tax rate, thereby artificially deflating its Puerto Rican income tax burden. Reflecting that purpose, the A.M.T. statute initially provided that the tax authorities in Puerto Rico could tax a related-party transaction at a lower rate if the transfer price paid by the taxpayer to the related entity was equal or substantially similar to the price at which the related party sold the property to others. The 2015 A.M.T. amendment eliminated this exemption.

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[1] *Wal-Mart Puerto Rico, Inc. v. Juan C. Zaragoza-Gomez*, 1st Cir., August 24, 2016, Docket Nos. 16-1370 and 16-1406.

Wal-Mart was the only corporation to meet the sales threshold for the top tangible property tax rate of 6.5%. As a result, its Puerto Rican tax increased from close to $20 million in prior years to approximately $46.5 million, of which approximately $32.9 million was attributable to the A.M.T. This amounted to a tax rate of 132% of its total annual income. Ultimately, Wal-Mart obtained an injunction preventing the application of the 2015 amendments and the Court of Appeals for the First Circuit affirmed the lower court.

"The interplay of normal tax and A.M.T. requires the preparation of a complete* pro forma *tax return. Of equal importance is the need to revise projections as tax laws are amended throughout the year."

CONCLUSION

The rationale for the decision in *Wal-Mart* is not material to this article. What is material is that a projection of expected tax expense by applying statutory income tax rates to simple projections of book income may yield results that materially underestimate actual tax. The interplay of normal tax and A.M.T. requires the preparation of a complete *pro forma* tax return. Of equal importance is the need to revise projections as tax laws are amended throughout the year.

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Tags
Foreign Ownership
Ireland
Real Estate
Tax Policy
Tax Treaties

2016-2017 PRIORITY GUIDANCE PLAN RELEASED

On August 15, the Department of Treasury issued its 2016-2017 Priority Guidance Plan.[1] The plan contains 281 projects to which resource allocations will be prioritized. The plan will be republished during the year to reflect the addition of new priorities and guidance. Comments and suggestions from taxpayers and tax practitioners are welcome.

In the international tax area, the 2016-2017 Priority Guidance Plan focuses on various areas, including Subpart F, Code §367 transactions, inversions, foreign tax credits, sourcing rules, and transfer pricing.

Several topics have been added or modified since the issuance of the 2015-2016 Priority Guidance Plan. In a number of areas, final, temporary, or proposed regulations were issued, such as

- final, temporary, and proposed regulations under Code §871(m), relating to dividend equivalent payments;
- proposed regulations regarding the transfer of property under Code §367(d), including foreign goodwill and going concern value;
- temporary and proposed regulations published regarding inversions and related transactions; and
- temporary and proposed regulations relating to transfer pricing matters.

Various projects were also added or revised in the 2016-2017 Priority Guidance Plan:

- F.I.R.P.T.A.-related regulations pursuant to the changes in the Protecting Americans from Tax Hikes Act of 2015
- Guidance on transfers of property to partnerships with related foreign partners and controlled transactions involving partnerships
- Guidance relating to country-by-country reporting requirements
- Regulations under §1256(g)(2) defining the definition of a foreign currency contract and likely excluding foreign currency options from that definition pursuant to the recent *Wright* case

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1 U.S. Department of the Treasury, *2016-2017 Priority Guidance Plan*, (Aug. 15, 2016).

Finally, certain projects are not on the Treasury Department's priority list anymore, such as the issuance of proposed regulations under Code §6038C on information with respect to foreign corporations engaged in a U.S. trade or business. Other projects, like guidance under Chapter 3 and Chapter 4 withholdings, were expanded.

U.S. AND IRELAND NEGOTIATE NEW INCOME TAX TREATY

In a press release dated August 25,[2] the Irish Department of Finance announced that discussions are ongoing between the U.S. Treasury and Ireland to update certain aspects of the U.S.-Ireland Income Tax Treaty. The current treaty was signed in 1997 and the subsequent protocol in 1999.

These discussions take place in the general context of the B.E.P.S. (Base Erosion and Profit Shifting) Project reports and the recently published 2016 U.S. Model Income Tax Treaty. It is expected that the revised U.S.-Ireland treaty will address

"It should be noted that the U.S. Senate has not approved a tax treaty or protocol since 2010."

- a reduction of treaty tax benefits in the case of an inversion (*i.e.*, where a U.S. corporation expatriates and certain other conditions are present),
- a reduction or denial of treaty benefits in the case of "special tax regimes," and
- treaty-shopping and changes to the treaty's "limitation of benefits" article.

The public consultation is led by Ireland's Department of Finance and Revenue Commissioners and is open until October 14, 2016. It calls for comments on the 2016 U.S. Model Income Tax Treaty from an Irish perspective. It also welcomes comments on the existing treaty between the U.S. and Ireland.

It should be noted that the U.S. Senate has not approved a tax treaty or protocol since 2010.

REMINDER TO FOREIGN OWNERS OF U.S. REAL PROPERTY: DISREGARDED ENTITIES ARE NOT "TRANSFERORS"

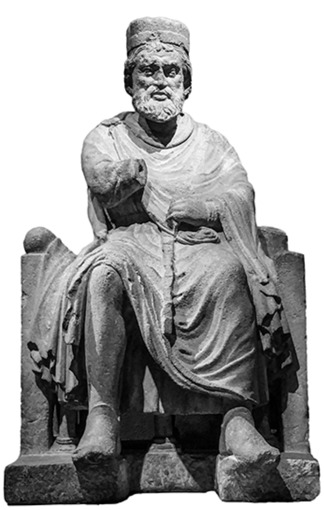
Single-member L.L.C.'s are often used to separate, as a corporate matter, an owner of an L.L.C. from a liability related to the underlying assets without creating the burden of an additional taxpaying entity. Beyond this accepted function, the I.R.S. believes that some foreign owners of U.S. real property may be using this tool as a way to avoid 15% F.I.R.P.T.A. withholding on sales of real property, by treating the sellers as domestic persons.

U.S. buyers of real property are generally required to withhold 15% of the purchase price for payments made to a foreign seller (absent the presence of an I.R.S.-issued

[2] "Consultation on Double Tax Treaty with the United States of America," Department of Finance, last modified Aug. 25, 2016.

withholding certificate that allows for a lower or zero withholding rate). This amount must be remitted to the I.R.S. within 21 days of the closing.

In late August, the Large Business & International ("LB&I") Division of the I.R.S. issued an International Practice Unit entitled "Taxation on Disposition of USPRI by Foreign Persons."[3] The document, which offers internal guidance for I.R.S. examiners, reminded auditors that a U.S. disregarded entity cannot certify that it is a U.S. transferor; the entity's owner must be treated as the transferor for F.I.R.P.T.A. withholding purposes. Buyer be warned.



3 I.R.S., *Taxation on Disposition of USPRI by Foreign Persons*, DCN: RPW/CU/P_08.4_05 (2016).

About Us

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

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

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

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

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