ruchelman
corporate
international
taxation

# INSIGHTS

## IMPACT OF THE TAX CUTS AND JOBS ACT ON U.S. INVESTORS IN FOREIGN CORPORATIONS

## A NEW TAX REGIME FOR C.F.C.'S: WHO IS G.I.L.T.I.?

## MODIFICATIONS TO THE FOREIGN TAX CREDIT SYSTEM UNDER THE TAX CUTS AND JOBS ACT

## CIRCULAR LETTER NO. 25/E CLARIFIES ITALY'S NEW CARRIED INTEREST REGIME

## AND MORE

Insights Vol. 5 No. 1

# TABLE OF CONTENTS



# EDITORS' NOTE

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

- **Impact of the Tax Cuts and Jobs Act on U.S. Investors in Foreign Corporations.** International tax planning in the U.S. has been turned on its head by the Tax Cuts and Jobs Act ("T.C.J.A."). This article looks at (i) the new dividends received deduction that eliminates U.S. tax on the receipt of direct investment dividends paid by a 10%-owned foreign corporation to a U.S. corporation, (ii) the repatriation of post-1986 net accumulated earnings of 10%-owned foreign corporations by U.S. persons and the accompanying deferred tax rules, (iii) changes to Code §367(a) that eliminate an exemption from tax on outbound transfers of assets that will be used in the active conduct of a foreign trade or business, and (iv) a broadening of the scope of Subpart F income by reason of a change to certain definitions. Rusudan Shervashidze and Stanley C. Ruchelman address and comment on these revisions.

- **A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?** The T.C.J.A. introduces a new minimum tax regime applicable to controlled foreign corporations ("C.F.C.'s"). It also provides tax benefits for income from "intangibles" used to exploit foreign markets. The former is known as G.I.L.T.I. and the latter is known as F.D.I.I. Together, G.I.L.T.I. and F.D.I.I. change the dynamics of cross-border taxation and can be seen as an incentive to supply foreign markets with goods and services produced in the U.S. Both provisions reflect a view that only two value drivers exist in business: (i) hard assets (such as property, plant, and equipment) and (ii) intangible property. In a detailed set of Q&A's, Elizabeth V. Zanet and Stanley C. Ruchelman look at the ins and outs of the new provisions.

- **Modifications to the Foreign Tax Credit System Under the Tax Cuts and Jobs Act.** The T.C.J.A. introduces new concepts in foreign tax credit planning and eliminates others. Gone are the pool of post-1986 earnings & profits and deemed-paid foreign tax credits for intercompany dividends. In their place is a dividends received deduction. Allocations of interest expense between foreign-source income and domestic income now must be based on tax book value. Entities that manufacture in one jurisdiction and sell in another will find that the source of income is controlled only by production activities. Neha Rastogi and Stanley C. Ruchelman explain.

- **New U.S. Tax Law Adopts Provisions to Prevent Base Erosion.** Following the lead of the O.E.C.D. and the European Commission ("E.C."), the T.C.J.A. adopts several provisions designed to end tax planning opportunities. In some instances, the new provisions closely follow their foreign counterparts. In others, the provisions that are specific to U.S. tax law. Among these changes are (i) the introduction of the G.I.L.T.I. minimum tax on the use of foreign intangible property by C.F.C.'s, (ii) the total revamp of Code §163(j) so that it reflects an interest ceiling rather than an earnings stripping provision, (iii) the restriction of tax benefits derived from the use of hybrid entities and transactions, (iv) the broadened scope of Subpart F through definitional changes, (v) legislative reversals of judicial decisions in which I.R.S. positions in transfer pricing matters were successfully challenged, and (vi) legislative reversals of a judicial decision invalidating Rev. Rul. 91-32 regarding the sale of partnership interests by foreign partner. Sheryl Shah and Stanley C. Ruchelman discuss these provisions and place them in context.

- **Circular Letter No. 25/E Clarifies Italy's New Carried Interest Regime.** Early last year, the Italian government announced new rules regarding favorable taxation of carried interests. Graduated tax rates and social charges would be replaced by a flat 26% tax on investment income. Towards the end of the year, guidelines were published by the Italian tax authorities providing significant clarifications on the scope, requirements, and conditions under the new tax regime. Andrea Tavecchio and Riccardo Barone of Tavecchio Caldara & Associati, Milan, examine how the new regime will work in practice.

- **Individual, Corporate, and Trust News from France.** The end of each year in France is marked by a fiscal legislative process to amend the current year's finance law and to draft the law for the upcoming year. The year 2017 was no exception. Changes will be made to wealth tax, tax brackets, tax on investment income, corporate tax rates, and the 3% additional tax on dividend distributions (retroactively). Fanny Karaman and Nina Krauthamer explain the tax changes.

- **Income Shifting: Common Ownership or Control Under Code §482 in an Inbound Transaction.** The Large Business and International Division of the I.R.S. ("LB&I") periodically develops international practice units ("I.P.U.'s") that serve as training material for international examiners. In November 2017, an I.P.U. entitled "Common Ownership or Control Under IRC 482 – Inbound" was published. On the same date, the I.R.S. issued a sister I.P.U. for outbound transactions, "Common Ownership or Control Under IRC 482 – Outbound." Together, they serve as a primer for determining whether sufficient control exists between two parties to bring the arm's length transfer pricing rules of Code §482 into play. Stanley C. Ruchelman explains how the I.R.S. trains its examiners when determining whether a transfer pricing adjustment is appropriate.

- **Updates & Tidbits.** This month, Neha Rastogi and Nina Krauthamer look briefly at three recent developments in international tax: (i) expired I.T.I.N.'s and how tax returns that use an expired I.T.I.N. will be treated by the I.R.S., (ii) the E.U. blacklist of uncooperative jurisdictions, which includes American Samoa and Guam, and (iii) and unanticipated tax demands on contributions to the Brexit campaign.

We hope you enjoy this issue.

- The Editors

# IMPACT OF THE TAX CUTS AND JOB ACT ON U.S. INVESTORS IN FOREIGN CORPORATIONS

**Authors**
Rusudan Shervashidze
Stanley C. Ruchelman

**Tags**
Code §245A
Code §367
Code §965
Code §91
D.R.D.
Outbound Transfers
Subpart F
T.C.J.A.
Transition Tax

## INTRODUCTION

This article addresses provisions of the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") that affect certain U.S. investors in foreign corporations on a go-forward basis and a one-year transition period for the 2017 taxable year.

## DIVIDENDS RECEIVED DEDUCTION FOR DIRECT INVESTMENT IN SPECIFIED FOREIGN CORPORATIONS

### Prior Law

Generally, individuals that are U.S. citizens or residents and domestic corporations are considered to be U.S. persons that are subject to tax on worldwide income.[1]

The American Jobs Creation Act of 2004 adopted Code §965, a temporary provision to encourage U.S. multinational companies to repatriate foreign earnings. During a specific period of time, certain dividends received by a U.S. corporation from a controlled foreign corporation ("C.F.C.") were eligible for an 85% dividends received deduction.

The temporary deduction was subject to a number of general limitations:

- It generally applied only to cash repatriations in excess of a base amount by reference to a three-year base period.
- The amount of dividend eligible for the deduction was generally limited to the amount of earnings identified in audited financial statements as being permanently invested outside the U.S., so that no deferred tax provision existed for potential U.S. tax at the time of a repatriation event.[2]
- To qualify for the deduction, dividends were required to be invested in the U.S. according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.

No foreign tax credit or deduction was allowed for foreign taxes attributable to the deductible portion of the dividend.[3] Taxpayers were permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not.

---

1 Code §7701(a)(30).

2 Financial Accounting Standard 109 (Accounting for Income Taxes).

3 Code §965(d)(1),(2).

## T.C.J.A.

### *In General*

Code §245A provides a 100% deduction for the foreign-source portion of dividends received from specified 10%-owned foreign corporations (the "D.R.D.") by domestic corporations that are U.S. Shareholders, within the meaning of Code §951(b), of the corporation making the distribution. The D.R.D. is available only to C-corporations that are not R.I.C.'s or R.E.I.T.'s. A specified 10%-owned foreign corporation is any foreign corporation[4] with respect to which a domestic corporation is a U.S. Shareholder, even if the foreign corporation is not a C.F.C.

The term "dividends received" is interpreted broadly, consistent with the meaning of the phrases "amount received as dividends" and "dividends received" under Code §§243 and 245. Thus, the dividend may be received directly or through a partnership, provided the indirect ownership percentage in the foreign corporation is at least 10%.

### *Foreign-Source Portion of a Dividend*

D.R.D. treatment is available only for the foreign-source portion of dividends received by a domestic corporation from a specified foreign corporation. The foreign-source portion of any dividend is the amount that bears the same ratio to the dividend as the undistributed foreign earnings bears to the total undistributed earnings of the foreign corporation. Undistributed earnings are the amount of the earnings and profits of a specified 10%-owned foreign corporation as of the close of the taxable year in which the dividend is distributed and not reduced by dividends distributed during that taxable year. Undistributed foreign earnings are the portion of the undistributed earnings attributable to neither income described in Code §245(a)(5)(A) nor Code §245(a)(5)(B), without regard to Code §245(a)(12).

***"D.R.D. treatment is available only for the foreign-source portion of dividends received by a domestic corporation from a specified foreign corporation."***

### *Hybrid Dividends*

The D.R.D. is not available for any dividend received by a U.S. Shareholder from a C.F.C. if the dividend is a hybrid dividend. A hybrid dividend is an amount for which a deduction would be allowed under the D.R.D. rules except that the specified 10%-owned foreign corporation received a deduction or other tax benefit in any foreign country. Where the foreign corporation benefitted from a tax deduction for the payment, the D.R.D.is not available to the recipient U.S. Shareholder.

> Example
>
> U.S. Corporation B is the sole shareholder of Foreign Corporation Y. Foreign Corporation Y issued a series of contingent participating equity certificates ("C-PEC's") to U.S. Corporation B. Among other provisions, the term of the C-PEC's is 100 years, no coupon is attached to the instrument, dividends are payable when and as declared by the Board of Directors, and only when and if the issuer has sufficient profits and cash flow. Under the law of its country of residence, Foreign Corporation Y is entitled to treat the C-PEC's as debt so that distributions are tax deductible. In the U.S., the C-PEC's are treated as equity and the distributions are treated as dividends. The C-PEC's are hybrid instruments and U.S. Corporation B is not entitled to the benefit of the D.R.D.

---

[4] Other than a P.F.I.C. that is not also a C.F.C.

If a C.F.C. with respect to which a domestic corporation is a U.S. Shareholder receives a hybrid dividend from any other C.F.C. with respect to which the same domestic corporation is a U.S. Shareholder, the hybrid dividend is treated for purposes of Code §951(a)(1)(A) as Subpart F income of the recipient C.F.C. (notwithstanding Code §954(c)(6)).[5] Consequently, the U.S. Shareholder must include an amount in gross income under Subpart F.

*Foreign Tax Credit Disallowance*

A U.S. corporation that receives a dividend that qualifies for the D.R.D. may not claim a foreign tax credit or deduction for foreign income taxes that are imposed on the payment. For purposes of computing the foreign tax credit limitation under Code §904(a), the dividend and any deductions properly allocable or apportioned to it are disregarded.

*Holding Period Requirement*

To be entitled to claim the benefit of the D.R.D., three conditions must be met:

- First, the domestic corporation must hold the requisite interest in the specified foreign corporation for more than 365 days in the 731-day period beginning on the date that is 365 days before the ex-dividend date in the declaration. Typically, dividends are declared with regard to shareholders owning shares on a specific date, known as the record date. If shares are publicly traded on an exchange, the exchange will set the ex-dividend date. The ex-dividend date typically is two business days before the record date.
- Second, the foreign corporation must be a specified 10%-owned foreign corporation at all times during the holding period.
- Finally, the taxpayer must be a U.S. Shareholder with respect to such specified 10%-owned foreign corporation at all times during the period.

The provision applies to distributions made after December 31, 2017. For purposes of determining a taxpayer's foreign tax credit limitation under Code §904, it applies to deductions claimed in taxable years beginning on or after December 31, 2017.

**Comment**

With this new provision, the U.S. effectively moves into a territorial tax system. In comparison to prior law, where domestic companies were taxed on worldwide income, the current law does not tax certain U.S. domestic companies on dividend income earned outside the U.S.

Note, however, the D.R.D. is not a full participation exclusion in a European sense: Capital gains derived from the disposition of a specified 10%-owned foreign corporation are not tax free. In that regard, the D.R.D. is more akin to the Canadian system of dividends from exempt surplus.

---

5 In broad terms, Code §954(c)(6) excludes a cross-border, intercompany payment of interest or royalties from being Foreign Personal Holding Company Income where the payment involves C.F.C.'s that are related and the payment is treated as an expense that reduces an item of income for the payor that is not an item of Subpart F income.

## MANDATORY REPATRIATION UNDER CODE §965

### Prior Law

Before the T.C.J.A., the principal anti-deferral mechanism of U.S. tax law was Subpart F. In specified circumstances, it caused a U.S. Shareholder of a C.F.C. to be taxed on a current basis on certain categories of income earned by the C.F.C. Tax was imposed on the U.S. Shareholder even if cash or property was not distributed. Deferral of income and U.S. tax was terminated immediately.

A C.F.C. generally is defined as any foreign corporation in which U.S. Shareholders own stock representing more than 50% of the voting power or value of the corporation. A U.S. Shareholder is a U.S. person who owned 10% or more of the total voting power of that foreign corporation.

If the U.S. Shareholder was a corporation, it could claim a foreign tax credit for the foreign taxes paid by the foreign corporation, whether or not a C.F.C., at the time dividends were received or an inclusion in income occurred by reason of Subpart F.[6] If foreign operations were conducted by a branch of a U.S. person, direct foreign tax credits could be claimed for the tax paid by the foreign branch. If a U.S. person received dividends, interest, or royalties, foreign withholding taxes imposed at the time of payment were also creditable.[7]

### T.C.J.A.

*Scope of Earnings and Profits Subject to the Transition Tax*

The transition from a foreign tax credit system to eliminate double taxation for intercompany dividends received from a C.F.C. or a 10%-owned foreign corporation that is not a C.F.C. requires that the post-1986 pool of deferred earnings and profits must be taken into account under the old system so that post-2017 earnings can benefit from the D.R.D. provided by new Code §245A. The pool of earnings is taken into account in the 2017 tax return, with an election to spread the tax payment over eight years.

New Code §965 requires any U.S. Shareholder of a specified foreign corporation to include in income its *pro rata* share of the accumulated post-1986 deferred foreign income of the corporation. A specified foreign corporation is a foreign corporation that has at least one U.S. person that owns shares representing 10% or more of the combined voting power of all classes of shares in the foreign corporation.[8] A P.F.I.C. that is not a C.F.C. is excluded from the list for that U.S. person.

The mechanism for requiring an inclusion of pre-effective-date foreign earnings is Subpart F but in a somewhat adjusted way for 10% shareholders of a foreign corporation that is not a C.F.C. Remember, the term "U.S. Shareholder" means a U.S. person that holds shares representing 10% or more of the voting power of the foreign corporation. A U.S. Shareholder of a specified corporation includes the deferred foreign income in its last taxable year that begins before January 1, 2018, as additional Subpart F income. The inclusion is the greater of the aggregate

---

6 Code §§902 and 960.

7 Code § 901.

8 Code §951(b).

post-1986 accumulated foreign earnings and profits as of November 2, 2017, or December 31, 2017, (whichever date is used is referred to as "measurement date"). In Notice 2018-13, the I.R.S. announced that all computations that are called for in the statute on or as of November 2, 2017, may be made on or as of October 31, 2017. The use of the month-end date must be elected by the taxpayer and is offered to ease the compliance obligation of measuring amounts on a date other than a month end.

This transaction applies to all the U.S. Shareholders – within the meaning of Subpart F – of a "deferred foreign income corporation." This means individuals as well as corporations. A deferred foreign income corporation is any specified foreign corporation that has accumulated post-1986 deferred income that is greater than zero. The portion of post-1986 earnings and profits does not include earnings and profits accumulated by the foreign corporation prior to the time it obtained the status of a specified foreign corporation with regard to the U.S. person holding its shares.

*Accumulated Post-1986 Deferred Foreign Income*

A specified foreign corporation's accumulated post-1986 deferred foreign income on the measurement date is based on all post-1986 foreign earnings and profits that are not previously taxed. Ignored for this purpose are earnings and profits that are attributable to income that is effectively connected with the conduct of a trade or business in the U.S., provided that such income is actually taxed in the U.S. If the U.S. business income is not taxed because of the application of an income tax treaty and the absence of a permanent establishment, the earnings and profits arising from the U.S. businesses are not excluded.

Also excluded are earnings and profits that are attributable to Subpart F income that has been included in the gross income of a U.S. Shareholder. In Notice 2018-13, the I.R.S. addressed a fact pattern in which a C.F.C. had 100u of post-1986 earnings and profits previously taxed for its U.S. Shareholder. In addition, in subsequent years it had deficits of 90u. Although the post-1986 accumulated profits are a positive 10u, for purposes of Code §965, the previously taxed income is not taken into account. Thus, the C.F.C. is a deficit C.F.C. and the deficit is 90u.

The pool of post-1986 foreign earnings and profits is not reduced by distributions during the taxable year to which Code §965 applies. This reflects the general ordering rule of Subpart F and actual dividends – Subpart F applies first and dividends are not taxed a second time if and to the extent attributable to previously taxed income. For individuals, this means they are taxed at ordinary income rates and not favorable long-term capital gains tax rates that might otherwise apply to qualified dividends.

As mentioned above, a U.S. Shareholder that is subject to Code §965 must determine its aggregate earnings and profits. This is determined on each of two dates and the date on which the amount is greatest is the measurement date.

The pool of post-1986 earnings and profits of a U.S. Shareholder is reduced by foreign earnings and profits deficits that are properly allocated to that U.S. Shareholder. If more than one specified foreign corporation is owned and some have net positive earnings and profits and others have deficits, the deficits will reduce the amount taken into income. The deficits are allocated among the specified foreign corporations on a *pro rata* basis determined by reference to positive earnings and profits among the specified foreign corporations owned.

Where a deficit C.F.C. has more than one class of shares, the deficit must be allocated among the various classes of shares, especially where unrelated persons hold separate classes. Notice 2018-13 addresses this fact pattern. The earnings and profits deficit is allocated first among the shareholders of the corporation's common stock and in proportion to the value of the common stock held by such shareholders.

*Distributions of Previously Taxed Income*

Code §961(d)(2) provides that to the extent that an amount excluded from gross income under Code §959(a) exceeds the adjusted basis of the stock in the C.F.C., the excess is treated as gain from the sale or exchange of property. Notice 2018-07 addressed a fact pattern in which a C.F.C. receives distributions from a C.F.C. with positive earnings and profits in 2017 that are attributable to previously taxed income by reason of the Subpart F inclusion under Code §965. The amount of gain recognized under Code §961(b)(2) will be reduced (but not below zero) by the Subpart F inclusion. This gain-reduction rule will extend to cover intermediate distributions within a chain of C.F.C.'s.

*Tax Rate Imposed on Inclusion*

Instead of prescribing a fixed tax rate on the Code §951 inclusion, Code §965 allows a deduction to be applied to net income that is calculated to achieve a specific tax rate. It is referred to as the rate equivalent percentage method. In substance, the equivalent of a partial D.R.D. is computed so that the tax imposed will equal the target rate when divided by net income before the deduction. As a result, the total deduction from the amount of the Code §951 inclusion is the amount necessary to result in a 15.5% rate of tax on accumulated earnings held in the form of cash or cash equivalents and an 8% rate of tax on all other earnings. The calculation is based on the highest rate of tax applicable to corporations in the taxable year of inclusion (*i.e.*, the last taxable year that begins before 2018) even if the U.S. Shareholder is an individual.

According to the Conference Committee Report, the use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. Shareholders, regardless of the year in which Code §965 gives rise to an income inclusion. Individual U.S. Shareholders, and investors in U.S. Shareholders that are pass-thru entities, generally can elect application of corporate rates for the year of inclusion. Code §962 is the basis of the election. Under that provision, the actual cash distribution by a C.F.C. to a U.S. individual is not treated as a dividend paid from previously taxed income. Instead, it generally is treated as if the dividend is received from the hypothetical U.S. corporation entitled to claim a credit for foreign income taxes paid by the C.F.C. As a result, there are two inclusions of income for U.S. income tax purposes: the Subpart F inclusion by the hypothetical U.S. corporation and the hypothetical dividend from that U.S. corporation. This could result in a tax that is greater than the tax paid by a corporation. That would not have occurred under the House Bill, which called for a reduced tax rate on the inclusion and no tax for U.S. Shareholders that are individuals. On the other hand, even where an actual U.S. corporation is a U.S. Shareholder, the individuals who are its shareholders would be taxed when the proceeds of a Subpart

F inclusion, received as a dividend from previously taxed income, are paid to the individuals as dividends.

In addition, the increase in income that is not taxed by reason of the partial D.R.D. is treated as income exempt from tax for purposes of determining the outside basis of an interest in a partnership or an S-corporation, but not as income exempt from tax for purposes of determining the accumulated adjustments account of an S-corporation.

***"The aggregate cash position of a U.S. Shareholder is the average of the sum of the shareholder's pro rata share of the cash position of each specified foreign corporation owned."***

The foreign taxes treated as paid or accrued by a domestic corporation are limited to those taxes in proportion to the taxable portion of the Code §965 inclusion.

*Determination of Cash Position*

For purposes of computing the tax on the inclusion of earnings represented by cash on the balance sheet, the statute provides a broad meaning to the term "cash." The cash position of an entity consists of all cash, net accounts receivables, and the fair market value of similarly liquid assets, specifically including personal property that is actively traded on an established financial market (other than stock in the specified foreign corporation) government securities, certificates of deposit, commercial paper, and short-term obligations. In Notice 2018-13, the I.R.S. announced that a loan that must be repaid on the demand of the lender or within one year of such demand will be treated as a short-term obligation, regardless of its stated term.

The cash position of a U.S. Shareholder in a specified foreign corporation generally does not include the cash attributable to a direct ownership interest in the partnership, unless the partnership would be a specified foreign corporation with respect to the U.S. Shareholder were the entity a foreign corporation. In broad terms, this means that the U.S. person must hold a 10% interest in the partnership.

To avoid double counting of cash assets, a U.S. Shareholder may disregard accounts receivable and short-term obligations of a specified foreign corporation if that shareholder can establish that the amounts have been taken into account already by that shareholder with respect to another specified foreign corporation.

The I.R.S. is authorized to expand the list of items that are economically equivalent to cash and to disregard transactions that have the principal purpose of reducing the aggregate foreign cash position. Specifically targeted are (i) a change in entity classification, accounting method, and taxable year, or (ii) intragroup transactions such as distributions or liquidations.

The aggregate cash position of a U.S. Shareholder is the average of the sum of the shareholder's *pro rata* share of the cash position of each specified foreign corporation owned. Two methods are provided for determining the cash position. The method that produces the greater amount of cash must be used.

- Under the first method, the cash of such specified foreign corporation is measured as of the close of the last taxable year which begins before January 1, 2018.
- Under the second method, the cash position is measured on the last day each of the two taxable years immediately preceding November 2, 2017, and is the average of the values on those two days.

*Limitations on Assessment Extended*

The limitations period for assessment of tax is six years from the date on which the return reflecting the Code §951 inclusion is filed.

*Installment Payments – In General*

A U.S. Shareholder may elect to pay the net tax liability resulting from the Code §951 inclusion in eight installments that are back-loaded as to amounts. In each of the first five years following the income inclusion, 8% of the tax must be paid. For the sixth year, the installment payment is 15% of the net tax liability reported in 2017. In the seventh year, the installment increases to 20% of the 2017 reported tax liability, and the final 25% is paid in the eighth installment. Payments are due on the due date of each year's tax return, determined without extensions. Interest generally does not accrue on the principal balance of tax due.

The eight-year payment period can be accelerated by the tax equivalent of a default. The events that trigger acceleration are any of the following:

- A failure to pay timely any required installment
- A liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case)
- The U.S. shareholder ceases business
- Another similar circumstance arises

The unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 case or similar proceeding, the day before the petition is filed).

*Installment Payments – S-Corporations*

Shareholders of an S-corporation may elect to defer the start of the eight-year payout period. The deferral is elected at the shareholder level, not the level of the S-corporation. The deferral continues until the occurrence of any of the three following events:

- A change in the status of the corporation as an S-corporation
- A liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy
- A transfer of shares of stock in the S-corporation by the electing taxpayer, whether by sale, death, or otherwise, unless the transferee of the stock agrees with the I.R.S. to be liable for net tax liability in the same manner as the transferor[9]

Because the deferral election is made at the level of a shareholder, an S-corporation must report the Code §965 inclusion amount and the deduction that is allowed to arrive at the proper amount of tax. The election to defer the tax is due not later than

[9] Note that partial transfers trigger the end of deferral for the portion of stock sold, and the S-corporation still has the reporting obligation.

the due date for the return of the S-corporation for its last taxable year that begins before January 1, 2018.

*Payment Period for R.E.I.T.'s*

A R.E.I.T. is an entity that, when properly set up and operated, allows individuals to (i) invest in real property, (ii) benefit from a diversified portfolio, (iii) have the investment managed professionally, and (iv) have income and gains taxed only at the investor level to the extent dividends are distributed. In essence, it is the equivalent of a mutual fund for real estate investments.

Like an S-corporation, a R.E.I.T. computes income but is not a taxpayer in most instances. Consequently, if a R.E.I.T. is a 10% investor in a specified foreign corporation or is a U.S. Shareholder of a C.F.C., it must determine its *pro rata* share of the increase in Subpart F income in accordance with the rules described above for other taxpayers. The Subpart F inclusion is taken into account for purposes of determining the R.E.I.T.'s taxable income under Code §857(b).

To prevent a R.E.I.T. from being exposed to U.S. tax if it fails to distribute the Subpart F inclusion to shareholders, a R.E.I.T. may elect to take amounts into income over a period of eight years. In each of those years, it may claim a proportional amount of the partial D.R.D. based on the percentage of Subpart F income recognized in that year. Beyond this deferred recognition provision, neither the R.E.I.T. nor the recipient of the distribution may elect to use the installment method to pay the tax. Should a R.E.I.T. be liquidated, cease to operate its business, or distribute substantially all its assets, the balance of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event.

## SALES OR TRANSFERS INVOLVING SPECIFIED 10%-OWNED FOREIGN CORPORATIONS

### Prior Law

As mentioned above, domestic corporations generally were taxed under a worldwide tax system, so that both U.S. and foreign-source income were taxed. Where a U.S. corporation was a U.S. Shareholder of a C.F.C. with Subpart F income, the U.S. corporation was required to include and pay tax on its *pro rata* share of Subpart F income, even if not distributed. Once a C.F.C.'s earnings were taxed under Subpart F in the hands of its U.S. Shareholder, those earnings were not again taxed when actually distributed in the form of a dividend.[10] Generally, a Subpart F inclusion in a U.S. tax return resulted in an increase in the U.S. Shareholder's basis. Subsequent actual distributions were treated as previously taxed income to the extent of previously taxed earnings and profits. This treatment applied to dividends distributed directly to a U.S. Shareholder and to upper-tier C.F.C.'s as dividends made their way up a corporate chain. In the absence of unusual circumstances, the actual distribution closed the loop beginning with the income inclusion, then the basis increase in shares held, and actual cash payment. Upon the receipt of the dividend from previously taxed income, no additional income was realized by the U.S. Shareholder and its basis in the shares of C.F.C. stock is reduced.

---

[10] Code §959(a)(1).

When the shares of a C.F.C. were sold, a portion of the value of the shares may have been attributable to retained earnings within the company. Code §1248 recharacterized gains on sale of C.F.C. stock as dividend income to the extent of previously untaxed earnings and profits attributable to the stock sold. This treatment ensured that deferred earnings were not converted into capital gains, which were taxed at more favorable rates in certain circumstances at different points in time.

## T.C.J.A.

### *Sales of Stock by U.S. Persons*

Any amount received in the case of the sale or exchange by a domestic corporation of a stock in a foreign corporation held for the requisite holding period, is treated as a dividend for purposes of the D.R.D., if it is treated as a dividend under Code §1248.

### *Accompanying Reduction in Basis When Determining Loss from Stock Sale*

Solely for the purpose of determining a loss from the sale of shares in a specified foreign corporation, a domestic corporate shareholder's adjusted basis in the stock of a specified 10%-owned foreign corporation is reduced by an amount equal to the portion of the D.R.D. received with respect to such stock. The reduction in basis is disregarded to the extent the basis in the specified 10%-owned foreign corporation's stock was previously reduced pursuant to Code §1059, relating to basis reduction resulting from the distribution of an extraordinary dividend.

### *Sale by a C.F.C. of a Lower-Tier C.F.C.*

Comparable treatment is provided for sales by C.F.C.'s in lower-tier C.F.C.'s.[11] Thus, if for any taxable year of a C.F.C., an amount is treated as a dividend under Code §964(e)(1) because of a sale or exchange by the C.F.C. of stock in another foreign corporation held for a year or more, the following treatment is provided:

- The foreign-source portion of the dividend is treated as Subpart F income of the selling C.F.C. for purposes of Code §951(a)(1)(A).
- A U.S. Shareholder with respect to the selling C.F.C. includes in gross income for the taxable year of the shareholder an amount equal to the shareholder's *pro rata* share[12] of the foregoing amount treated as Subpart F income.
- The deduction under Code §245A(a) is allowable to the U.S. Shareholder with respect to the Subpart F income included in gross income in the same manner as if the Subpart F income were a dividend received by the shareholder from the selling C.F.C.

## Comment

For U.S. individuals that have invested in a foreign corporation that does not qualify for treaty benefits under an income tax treaty with the U.S., consideration should be given to creating a U.S. corporation to hold the shares of that foreign corporation. The D.R.D. does not contain the any requirement under which the corporation paying the dividend must qualify for benefits under a tax treaty with the U.S.

[11] Code §964(e)(4).

[12] Determined in the same manner as under Code §951(a)(2).

Consequently, the U.S. corporation may claim the D.R.D., and the dividend to a U.S. individual is a qualified dividend.

## ACTIVE TRADE OR BUSINESS EXCEPTION REPEALED FOR ASSET TRANSFERS TO FOREIGN CORPORATIONS

### Prior Law

Code §367(a)(1) provided that transfers of appreciated property by a U.S. person to a foreign corporation in connection with any exchange described in Code §§332 (subsidiary liquidation into a parent corporation), 351 (transfer to a controlled corporation, generally upon incorporation), 354 (exchange of shares incident to a reorganization), 355 (corporate spinoff of a business to shareholders), or 361 (transfer of assets incident to a reorganization) was currently taxable to the transferor. Several exceptions were provided to the mandatory recognition. Among them, Code §367(a)(3)(A) provided that, subject to any claw-back provision in the I.R.S. regulations, gain would not be recognized in connection with a transfer of property to a foreign corporation for use in the active conduct of a trade or business conducted outside of the U.S.

### T.C.J.A.

The T.C.J.A. amended Code §367(a) by eliminating the exception for transfers of property to a foreign corporation that will be used by that corporation in the active conduct of a trade or business. Transfers of those assets are now subject to recognition of inherent gain even if used in a trade of business by the foreign corporation.

The provision is effective for transfers made after December 31, 2017.

## INCORPORATION OF FOREIGN BRANCH WITH ACCUMULATED LOSSES

### Prior Law

Under Code §367(a)(3)(C) of prior law, a domestic corporation that transferred substantially all of the assets of a foreign branch to a specified 10%-owned foreign corporation with respect to which it was a U.S. Shareholder after the transfer was required to include in gross income an amount equal to the transferred loss amount, subject to certain limitations. The transferred loss amount was

- the amount by which accumulated losses incurred by the foreign branch for which a deduction was allowed to the domestic corporation exceeded
- the sum of certain taxable income earned by the foreign branch.

The provision focused on the losses of a specific branch. If the U.S. corporation operated several branches that reported a net loss in the aggregate, the overall foreign loss recapture rules were applied prior to the branch loss recapture rules. Consequently, if gain were recognized by reason of the overall foreign loss recapture rules, that gain was added to the taxable income of the branch for purposes of the branch recapture rules.

*"Foreign tax credit planning strategies designed to maximize credits while minimizing income have come to an end."*

For purposes of the branch loss recapture rules, only taxable income of the foreign branch in taxable years after a loss was first incurred was taken into account. The transferred loss amount was reduced by the amount of gain recognized by the taxpayer on account of the transfer. Gross income recognized on the transfer was treated as derived from U.S. sources so that U.S. tax could not be reduced by a foreign tax credit.

### T.C.J.A.

As mentioned above, the T.C.J.A. repealed the general exemption from tax for transfers to a foreign corporation of certain assets that would be used in the active conduct of a trade or business abroad. The exemption was granted under Code §367(a)(3). When that Code section was repealed, the gain recognition provision for transfers of substantially all of the assets of a foreign branch having accumulated net losses was also repealed.

The T.C.J.A. adopts Code §367(a)(3)(C) of prior law as new Code §91. The amount of gain taken into account under Code §91 is reduced by the amount of gain recognized under Code §367(a)(3)(C) of prior law with respect to losses incurred before January 1, 2018. This allows the prior law provision to control through the end of 2017 and Code §91 to apply once the old law is no longer effective.

## CONCLUSION

The new territorial tax system may require companies to reexamine their business structures with regard to international operations. In addition, the transitional rule regarding mandatory repatriation of post-1986 earnings and profits of foreign subsidiaries will affect all U.S. corporations or U.S. individuals that own 10% or more of the voting shares in a foreign corporation, directly or through a tax transparent entity. Foreign tax credit planning strategies designed to maximize credits while minimizing income have come to an end. With the elimination of Code §960(c), which addresses the foreign tax credit that may be claimed when a C.F.C. makes a taxable investment in U.S. property, perhaps the foreign tax credit can be computed in a more straightforward way.[13]

---

[13] In 2010, Code §960(c) was adopted to prevent U.S.-based multinational groups from increasing foreign tax credits by making a taxable investment in U.S. property, which would occur if a loan were made to a related party in the U.S. Under the "hopscotch" rule of Code §956, the income flowed directly from the C.F.C. investor to the U.S. Shareholder. The tax credit for an inclusion under Code §956 could be greater than the available credit from an actual distribution of a similar amount up a chain of corporations. As such distributions no longer generate taxable income or creditable taxes, there apparently is no reason for the concept of Code §960 to outlive its actual presence in U.S. tax law.

# A NEW TAX REGIME FOR C.F.C.'S: WHO IS G.I.L.T.I.?

**Authors**
Elizabeth V. Zanet
Stanley C. Ruchelman

**Tags**
C.F.C.
Deemed-Paid Foreign Tax Credit
F.D.I.I.
G.I.L.T.I.
Q.B.A.I.
T.C.J.A.
Tested Income
U.S. Shareholder

## INTRODUCTION

The 2017 Tax Cuts and Jobs Act introduces a new tax regime applicable to controlled foreign corporations ("C.F.C.'s"). As discussed in detail below, Code §§951A and 250 will generally result in the following:

- A C.F.C.'s global intangible low-taxed income ("G.I.L.T.I.") will pass through to its "U.S. Shareholders" (a term broadened under the new law) as a current year income inclusion.
- In the case of a U.S. corporation (other than a regulated investment company or real estate investment trust), a deduction for foreign-derived intangible income ("F.D.I.I.") and G.I.L.T.I. will be allowed against its G.I.L.T.I. inclusion.

The G.I.L.T.I. regime is designed to decrease the incentive for a U.S. group to shift corporate profits to low-tax jurisdictions. In this way, it protects the new participation exemption regime[1] by preventing mobile intangible income from being used to reduce U.S. taxable income for the payer while preventing the payer's group from obtaining the benefit of the dividend received deduction for dividends from a C.F.C. that received G.I.L.T.I. As stated in the Conference Committee Report:

> Changing the U.S. international tax system from a worldwide system of taxation to a participation exemption system of taxation exacerbates the incentive under present law to shift profits abroad. Specifically, under present law, most foreign profits earned through a subsidiary are not subject to current taxation but will eventually be subject to U.S. taxation upon repatriation. Under the participation exemption system provided for in the bill, however, foreign profits earned through a subsidiary generally will never be subject to U.S. taxation. Accordingly, new measures to protect against the erosion of the U.S. tax base are warranted.

The deduction allowed for F.D.I.I. and G.I.L.T.I. provides a reduced effective tax rate for G.I.L.T.I. of 10.5%, which is increased to 13.125% after 2025.

This article takes a question and answer approach to examining the new Code §§951A and 250, and revised Code §960. Throughout, new terms are used, new concepts of taxation are applied, and the rules zigzag between looking at C.F.C.'s in the aggregate and looking at each individually.

---

1 See "Impact of the Tax Cuts and Job Act on U.S. Investors in Foreign Corporations" in this edition of *Insights*.

# COMPONENTS OF THE G.I.L.T.I. PROVISION

**1. What is a C.F.C. and how has the definition been changed?**

Under prior and current law, a C.F.C. is any foreign corporation in which U.S. Shareholders (defined below) own more than 50% of the foreign corporation's stock by value or vote.

Under prior law, a foreign corporation was required to be controlled for 30 days before the Subpart F rules applied. Under the new law, the 30-day requirement is no longer in effect.

Under prior law, a U.S. Shareholder was defined as a U.S. person that owned 10% or more of the foreign corporation's voting stock. Under the new law, the definition includes a U.S. person that owns 10% or more of the foreign corporation's stock by value. In addition, the attribution rules for determining constructive ownership of a foreign corporation by a U.S. person are expanded to include attribution from a foreign person to a U.S. person.

**2. How does the Subpart F tax regime treat a U.S. Shareholder of a C.F.C. with regard to Subpart F income?**

The Subpart F tax regime identifies certain income of a C.F.C. as "tainted" income and requires a U.S. Shareholder of that C.F.C. to automatically include the earnings from that income in its U.S. tax return. When those earnings are distributed in the form of a dividend, the U.S. Shareholder generally treats the dividend as previously taxed income, which is not taxed a second time.

Several forms of tainted income are included in the definition of Subpart F income. Included are items of passive income and mobile income, known as Foreign Personal Holding Company Income ("F.P.H.C.I."). F.P.H.C.I. includes dividends, interest, royalties, and certain gains. From the viewpoint of legislative policy, F.P.H.C.I. can easily be transferred from a company in one country to an affiliated company in another country, pursuant to a search for an acceptably low rate of income tax.

**3. How is the traditional policy of Subpart F changed by the G.I.L.T.I. Provision?**

In comparison to the traditional approach that looks for specific items of tainted income, the G.I.L.T.I. provision provides a "safe zone" for a portion of the entire pool of C.F.C. earnings. The safe zone is based principally on a hypothetical yield generated by the C.F.C. on its Qualified Business Asset Investment ("Q.B.A.I."), determined on a pre-tax basis. Once the safe zone is computed, all additional earnings of the C.F.C. not otherwise taxed under Subpart F or specifically excepted by the statute are considered to be attributable to G.I.L.T.I.

**4. When does the G.I.L.T.I. regime first becomes effective?**

For foreign corporations, the G.I.L.T.I. regime is effective for tax years beginning after December 31, 2017. For U.S. Shareholders, the regime is effective for tax years in which or with which the tax year of the foreign corporation ends.

## 5. Which U.S. Shareholders of a C.F.C. must include G.I.L.T.I. in taxable income and how much must be included?

Under Code §951A(a), each person that is a U.S. Shareholder of a C.F.C. for any tax year is the U.S. person that must include in gross income such shareholder's G.I.L.T.I. for such tax year. In Code §951A(e)(3), the statute provides that a foreign corporation is treated as a C.F.C. for any tax year if it is a C.F.C. at any time during such tax year. The statute provides, in Code §951A(e)(2), that a person is treated as a U.S. Shareholder of a C.F.C. for a given tax year only if it owns stock in the foreign corporation on the last day in the tax year of the foreign corporation on which it is a C.F.C. Ownership includes direct ownership and indirect ownership under Code §958(a).

Finally, the statute provides in Code §951A(e)(1) that in determining *pro rata* shares of G.I.L.T.I., including net C.F.C. tested income in Code §951A(b) and Code §951A(c)(1)(A) and (B), the rules of Code §951(a)(2) apply in the same manner as to Subpart F income. Under that provision, Subpart F income is prorated to account for part-year ownership and dividend payments to prior owners, including amounts that are treated as dividends by reason of Code §1248.

These rules, apparently, are designed to provide a straightforward answer, but that answer is not always clear when ownership changes occur.

*No Change in Ownership*

If ownership does not change during the year, the same U.S. Shareholders that included G.I.L.T.I. in income for the prior year, will do so again. The amount takes into account each U.S. Shareholder's proportional amount of net C.F.C. tested income and the deemed return on Q.B.A.I. *Pro rata* presumably refers to the percentage of ownership interest and rights to dividend flow.

*Acquisition of Ownership Interest During the Year*

Now, the computation becomes somewhat unclear.

If we assume that all the shares of the target foreign company are purchased from a single seller that is a foreign member of a foreign-based multinational group, it seems that the reference to the *pro rata* rule of Code §951(a)(2) should mean that the computations are prorated to take into account part-year ownership. Thus, the acquirer is a U.S. Shareholder at the end of the year, the foreign corporation is a C.F.C., and G.I.L.T.I. is included on a *pro rata* basis.

On the other hand, if we assume that all the shares of the target foreign company are purchased from a single seller that is a U.S. corporation or that is a foreign member of a U.S.-based multinational group, it seems that the reference to the *pro rata* rule of Code §951(a)(2) contains uncertainty. In principle, the acquisition company is a U.S. Shareholder for only a portion of the year. Hence, G.I.L.T.I. could only be prorated to the tested income and return on Q.B.A.I. for the period of ownership. This would make sense but for the fact that it is not clear that the seller has any G.I.L.T.I. to report for the portion of the year it is a U.S. Shareholder of the C.F.C.: Only U.S. Shareholders on the last day of the year include G.I.L.T.I. and the seller is not a U.S. Shareholder on the last day.

*Disposition of Ownership in the Middle of a Year*

Comparable issues apply at the time of a disposition of shares of a C.F.C. If there is a disposition transaction that takes place in the middle of a year and all U.S. Shareholders sell their shares to a foreign acquisition company that is a member of a foreign-based multinational group, the U.S. Shareholders of the C.F.C. on the last day in the year on which the foreign corporation is a C.F.C. must include G.I.L.T.I. The statute is clear.

On the other hand, if the purchaser is a member of a U.S.-based group, the status of the foreign corporation as a C.F.C. continues on and the U.S. Shareholder does not have a taxable event under Code §951A(a). From a policy standpoint, a literal application of the statute would place the entire burden on the purchaser, except that it could benefit from the proration rule.

It is unlikely that Congress intended there to be a tax benefit bestowed on the selling party that is not offset by a tax cost on the purchasing party when unrelated U.S. groups are on both sides of a stock purchase transaction. Presumably, this can be addressed in a technical corrections bill.

### 6. What taxable events are deemed to occur for a U.S. Shareholder when a C.F.C. has G.I.L.T.I.?

Under Code §951A, a U.S. Shareholder of a C.F.C. must include in its gross income its G.I.L.T.I. inclusion in a manner similar to inclusions of Subpart F income. In broad terms, this means that a U.S. Shareholder must include in income the amount of income that would have been distributed with respect to the stock that it owned (within the meaning of Code §958(a)) in the C.F.C. if, on the last day in its tax year on which the corporation is a C.F.C., it had distributed *pro rata* to its shareholders an amount equal to the amount of its G.I.L.T.I.

When a U.S. Shareholder is a corporation, several rules apply in addition to the income inclusion. First, a deemed-paid foreign tax credit is allowed under Code §960 for foreign income taxes allocable to G.I.L.T.I. at the level of the C.F.C. Second, the Code §951A inclusion includes a "gross-up" under Code §78 for the foreign income taxes claimed as a credit. Third, the U.S. corporation is entitled to a 50% deduction (reduced to 37.5% in later tax years) based on the G.I.L.T.I. included in income. As a result, a corporate U.S. Shareholder's effective tax rate on G.I.L.T.I. plus the gross-up will be 10.5% (increased to 13.125% in later tax years).

### 7. How Is G.I.L.T.I. computed?

G.I.L.T.I. is determined through several computations that appear in Code §951A.

*G.I.L.T.I. Defined*

With respect to a U.S. Shareholder of a C.F.C., G.I.L.T.I. means the excess of (i) the shareholder's "net C.F.C. tested income" for the shareholder's tax year over (ii) the "net deemed tangible income return." This is expressed in the following formula:

**G.I.L.T.I. = Net C.F.C. Tested Income – Net Deemed Tangible Income Return**

Where a U.S. Person is a U.S. Shareholder of several C.F.C.'s, G.I.L.T.I. is computed on an aggregate basis that takes into account all its C.F.C.'s. The positive net tested income of each C.F.C. within the group that has positive income is added together to arrive at aggregate positive net tested income. At the same time, the net tested loss of each C.F.C. within the group within the group that has a loss is added together to arrive at aggregate net tested loss. The aggregate positive net tested income is reduced by the aggregate net tested loss to determine G.I.L.T.I.

### *Net Deemed Tangible Income Return Defined*

The U.S. Shareholder's net deemed tangible income return is (i) 10% of the aggregate of the shareholder's *pro rata* share of the Q.B.A.I. (defined below) of each of its C.F.C.'s, reduced by (ii) the interest expense of each C.F.C. that is taken into account in determining the shareholder's net C.F.C. tested income. Here, interest expense means the C.F.C.'s interest expense minus its interest income. This is expressed in the following formula:

$$\textbf{G.I.L.T.I.} = \begin{array}{c}\textbf{Net C.F.C.}\\ \textbf{Tested Income}\end{array} - (\,\textbf{0.1} \times \textbf{Q.B.A.I.}\,) - \begin{array}{c}\textbf{Net Interest Expense}\\ \textbf{Allocated to}\\ \textbf{Net Tested Income}\end{array}$$

In making the computation, the full amount equal to 10% of Q.B.A.I. cannot be reduced below zero by net interest expense. Stated differently, the net interest expense allocated to 10% of Q.B.A.I. is capped at 10% of Q.B.A.I.

### *Net C.F.C. Tested Income Defined*

Net C.F.C. tested income is the aggregate of (i) the U.S. Shareholder's *pro rata* share of the "tested income," if any, of each of its C.F.C.'s, reduced by (ii) the U.S. Shareholder's *pro rata* share of the "tested loss," if any, of each of its C.F.C.'s. This is expressed in the following formula:

$$\begin{array}{c}\textbf{Net C.F.C.}\\ \textbf{Tested Income}\end{array} = \begin{array}{c}\textbf{Sum of C.F.C.}\\ \textbf{Tested Income}\end{array} - \begin{array}{c}\textbf{Sum of C.F.C.}\\ \textbf{Tested Loss}\end{array}$$

Tested income of a C.F.C. consists of (i) its gross income, excluding certain exceptions, reduced by (ii) its deductions (including taxes) that are properly allocable to such gross income. The exceptions to gross income are as follows:

- An item of income of a C.F.C. from sources within the U.S. that is effectively connected with the conduct of a trade or business within the U.S.
- Gross income of a C.F.C. taken into account in determining Subpart F income
- Gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under Code §954(b)(4) for income subject to an effective rate imposed by a foreign country greater than 90% of the maximum rate of tax specified in Code §11 (which is 21%)
- Dividends received from a related person
- Foreign oil and gas extraction income and foreign oil-related income

The income from sources within the U.S. that is effectively connected with the conduct of a U.S. trade or business must be taxed in the U.S. in order for it to be removed from gross income. Consequently, if the effectively connected income is exempt from U.S. tax or is subject to a reduced U.S. tax rate, it is removed from the list of exceptions to the extent of the benefit. Thus, if a treaty fully exempts the income, the income is fully removed from the exception. On the other hand, if the treaty merely reduces U.S. tax, only a *pro rata* portion of the income is removed from the list of exceptions, based on the percentage by which U.S. tax is reduced.

***"Q.B.A.I. means investment in property, plant, and equipment adjusted to reflect depreciation expense using longer lives set forth in Code §168(g)."***

Tested loss of a C.F.C. is the excess of (i) deductions (including taxes) properly allocable to the corporation's gross income, not including the tested income exceptions, reduced by (ii) the amount of such gross income.

*Q.B.A.I. Defined*

Q.B.A.I. means, with respect to a C.F.C., the average of the aggregate of the adjusted bases in specified tangible property used in a trade or business and of a type for which a deduction for depreciation generally would be allowable under Code §167. In terms typically used by corporate management, Q.B.A.I. means investment in property, plant, and equipment adjusted to reflect depreciation expense using longer lives set forth in Code §168(g). Under that provision of U.S. tax law, an alternative depreciation system is applied, *inter alia*, to tangible property used predominantly outside the U.S. The average bases of the assets in the computation is determined by reference to the adjusted bases as of the close of each quarter of the tax year. This reduces the positive and negative effects of asset acquisitions or dispositions during the year.

Specified tangible property means any property used in the production of tested income. Where property is used in part for the production of tested income and in part for the production of excepted income, the adjusted basis must be allocated between the two in the same proportion that the tested income bears to the total gross income arising from the use of the property.

If a C.F.C. holds an interest in a partnership, the C.F.C.'s distributive share of the aggregate of the partnership's adjusted bases in its assets must be taken into account for purposes of computing the Q.B.A.I. for the year.

**8. When a U.S. person is a U.S. Shareholder of several C.F.C.'s, how is the G.I.L.T.I. amount included in the U.S. Shareholder's income allocated among C.F.C.'s?**

When a U.S. person is a U.S. Shareholder of several C.F.C.'s, the amount of G.I.L.T.I. included in the income of the U.S. Shareholder is allocated on a *pro rata* basis among the C.F.C.'s having positive tested income. None of the G.I.L.T.I. is allocated to a C.F.C. that has negative tested income. The allocation method is expressed in the following formula with regard to each C.F.C. having positive net C.F.C. tested income:

$$\text{Portion of G.I.L.T.I. Allocated to C.F.C.} = \text{U.S. Shareholder's G.I.L.T.I.} \times \frac{\text{C.F.C. Tested Income Allocated to U.S. Shareholder}}{\text{Aggregate Tested Income of All C.F.C.'s of U.S. Shareholder}}$$

The allocation affects the computation of the deemed-paid foreign tax credit and the Code §78 gross up computation for each C.F.C. within the group.

9. **<u>Does a G.I.L.T.I. inclusion constitute Subpart F income of a U.S. Shareholder?</u>**

No. The G.I.L.T.I. inclusion by a U.S. Shareholder does not constitute an inclusion of Subpart F income. Nonetheless, G.I.L.T.I. inclusions are generally treated in a manner that is similar to Subpart F inclusions for purposes of applying Code §§168(h)(2)(B), 535(b)(10), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4). Among other things, this means that a U.S. Shareholder that is an individual should be allowed to compute the tax on an inclusion of G.I.L.T.I. under Code §962 as if the individual were a U.S. corporation with respect to the G.I.L.T.I. This would reduce the tax imposed on G.I.L.T.I. by the amount of the deduction allowed under Code §250. Dividends actually received by such U.S. Shareholder would then be taxed as qualified dividends paid by a U.S. domestic corporation, even if the C.F.C. distributing an actual dividend is based in a jurisdiction that does not have an income tax treaty in effect with the U.S. In addition, the previously taxed income rules under Code §959(a)(1)(A) would ensures that Subpart F should not apply to dividends that flow up a chain of C.F.C.'s., other than in limited circumstances.

10. **<u>Can a U.S. corporation claim an indirect foreign tax credit for taxes properly allocable to tested income of a C.F.C.?</u>**

Yes, a foreign tax credit is provided, but it is subject to relatively strict terms and conditions that are not typically found in the foreign tax credit provisions under U.S. law.

*<u>Foreign Tax Credit Allowed</u>*

For G.I.L.T.I. that is included in the gross income of a domestic corporation (including, for this purpose, an individual who elects to be taxed as a corporation), a "deemed-paid" foreign tax credit will be allowed. The credit equals 80% of the product of the corporation's "inclusion percentage" multiplied by the "aggregate tested foreign income taxes" paid or accrued by C.F.C.'s. This is expressed in the following formula:

***"The 80% cap on creditable foreign income taxes applicable to G.I.L.T.I affects the overall combined rate of foreign and U.S. income tax."***

$$\text{Deemed-Paid Foreign Tax Credit} = (0.8 \times \text{Inclusion Percentage}) \times \text{Aggregate Tested Foreign Income Taxes}$$

For computational reasons, the 80% cap on creditable foreign income taxes applicable to G.I.L.T.I affects the overall combined rate of foreign and U.S. income tax. This is discussed below.

*<u>Inclusion Percentage and Tested Foreign Income Taxes Defined</u>*

The inclusion percentage of a domestic corporation is determined by dividing (i) the corporate U.S. Shareholder's total G.I.L.T.I. (aggregate tested income of each C.F.C. in excess of 10% of all C.F.C.s' Q.B.A.I. and net interest expense) by (ii) the aggregate amount of its *pro rata* share of the tested income for each C.F.C. of which it is a U.S. Shareholder. As discussed above, tested income means gross income, reduced by income that is excepted, and reduced further by deductions properly allocable to the gross income.

Tested foreign income taxes of a C.F.C. means foreign income taxes paid or accrued by the C.F.C. that are attributable to tested income. Tested foreign income taxes do not include any foreign income tax paid or accrued by a C.F.C. that is properly attributable to the C.F.C.'s tested loss.

*Deemed-Paid Foreign Tax Credit and Gross-up*

The deemed-paid foreign tax credit is similar to the indirect foreign tax credit under the now-repealed Code §902, except the deemed-paid credit is limited to 80% of the foreign taxes paid. The foreign taxes deemed to have been paid increase G.I.L.T.I. in the same manner as the Code §78 gross-up. Consequently, the amount grossed up is equal to the entire amount of the inclusion percentage and aggregate tested foreign income taxes, even though only 80% are used when computing the deemed-paid credit. The Code §78 gross-up can be expressed in the following formula with regard to each C.F.C. having positive net C.F.C. tested income:

$$\textbf{Code §78 Gross-up} = \frac{\textbf{G.I.L.T.I.}}{\textbf{Aggregate Tested Income}} \times \textbf{Aggregate Tested Foreign Income Taxes}$$

The provision creates a separate foreign tax credit basket for G.I.L.T.I., with no carryforward or carryback available for excess credits. For purposes of determining the foreign tax credit limitation, G.I.L.T.I. is not general category income, and income that is both G.I.L.T.I. and passive category income is considered passive category income.

*Illustration 1*

To illustrate how the computation works, assume that Corp. A is a domestic corporation that is the sole shareholder of C.F.C. X., its only C.F.C. Corp. A has a manufacturing plant in the country in which C.F.C. X is located.

The Form 5471 prepared by Corp. A with regard to C.F.C. X reports the following:

| | | |
|---|---|---|
| • | Gross income from: | |
| | ○ Foreign base company sales operations | $100X |
| | ○ In-country sales operations | 50X |
| | ○ Investment income | 10X |
| | ○ Total gross income | $160X |
| • | Operating expenses related to: | |
| | ○ Foreign base company sales operations | $30X |
| | ○ In country sales operations | 8X |
| | ○ Investment income | 0X |
| | ○ Total expenses | $38X |
| • | G&A expenses | $5x |
| • | Net income before tax | $117X |
| • | Foreign income tax @25% (rounded down) | $29X |
| • | Net earnings after foreign income tax | $88X |

Assume further that the average adjusted basis in the property, plant, and equipment ("P.P.&E.") of C.F.C. X is $250 and C.F.C. X does not have interest expense.

The relevant computations are as follows:

- The tested gross income of C.F.C. X is $50X, comprised of its total gross income of $160X, reduced by excepted income of $110X attributable to its two items of Subpart F gross income (*i.e.*, foreign base company sales gross income of $100X and foreign personal holding company gross income of $10X).
- The operating expenses of C.F.C. X attributable to in-country sales are $8X and the G&A expenses allocated to the in-country sales, computed using an apportionment ratio based on the ratio of in-country sales to total operating gross income (*i.e.*, 50X ÷ 150X = 0.33), are $2X rounded up. Investment income has no operating or G&A expenses allocated to it. Foreign income tax is apportioned based on the relationship of (i) net tested income before tax for in-country sales ($40) to (ii) total net income before tax and is $10X rounded up (*i.e.*, 40X ÷ 117X x 29X).
- As a result, the net tested loss (*i.e.*, deductions, including taxes) allocated to the tested income of $50X is $20X (*i.e.*, $8X + $2X + $10X).
- 10% of Q.B.A.I. is $25X (*i.e.*, 250X x 0.1).
- C.F.C. X's net tested income is tested income ($50X) minus tested loss ($20X) and is $30X.
- Corp. A's G.I.L.T.I. inclusion is net tested income ($30X) in excess of 10% of C.F.C. X's Q.B.A.I. ($25X) and is $5X.
- The inclusion percentage for the purpose of computing the deemed-paid credit is 10%.
- Corp. A's foreign tax credit before the 80% cap on the deemed-paid credit is $1X (*i.e.*, 0.1 x $10X).
- Corp. A's foreign tax credit after the 80% cap is $0.80X (*i.e.*, $1X x 0.8).
- The foreign tax credit is placed in a separate limitation pool and any excess credit for the year is lost.

*Illustration 2*

Assume that Corp. B is a domestic corporation that is the sole shareholder of C.F.C. Y, its only C.F.C. Both Corp. B and C.F.C. Y are software engineering companies that use independent contractors based in Eastern Europe. Non-U.S. customers are serviced by C.F.C. Y. For the purpose of this example, C.F.C. Y does not have any foreign base company sales or services income that might be taxed under Subpart F or investment income.

The Form 5471 prepared by Corp. B with regard to C.F.C. Y reports the following:

| | | |
|---|---|---|
| • Gross income from: | | |
| | ○ Non-U.S. customers | $50X |
| | ○ Total gross income | $50X |
| • Operating expenses related to: | | |
| | ○ Gross income from non-U.S. customers | $4X |
| | ○ Total expenses | $4X |
| • G&A expenses | | $1x |
| • Net income before tax | | $45X |
| • Foreign income tax @25% (rounded down) | | $11X |
| • Net earnings after foreign income tax | | $34X |

Since C.F.C. Y uses independent contractors, it does not have P.P.&E. Further, we assume that C.F.C. Y does not have interest expense.

The relevant computations are as follows:

- The tested gross income of C.F.C. Y is $50X.
- The operating expenses of C.F.C. Y for in-country sales are $4X, the G&A expenses are $1X, and the foreign income tax is $11X.
- The deductions, including taxes, allocated to the tested income of $50X is $16X (*i.e.*, $4X + $1X + $11X).
- Q.B.A.I. is zero because C.F.C. Y does not have specified tangible property.
- C.F.C. Y's net tested income is tested income ($50X) minus deductions ($16X) and is $34X.
- Corp. B's G.I.L.T.I. inclusion is net tested income ($34X) in excess of 10% of C.F.C. Y's Q.B.A.I. ($0) and is $34X.
- The inclusion percentage for the purpose of computing the deemed-paid credit is 68%.
- Corp. B's foreign tax credit before the 80% cap on the deemed-paid credit is $8X rounded up (*i.e.*, 0.68 x $11X).
- Corp. B's foreign tax credit after the 80% cap is $6X rounded down (*i.e.*, $8X x 0.8).

In each illustration, once the amount of the G.I.L.T.I. inclusion is determined for the domestic corporation, it is entitled to a statutory deduction that reduces the tax rate to an attractive percentage. This is discussed below in conjunction with a comparable deduction for F.D.I.I.

The above illustrations show that U.S. Shareholders whose businesses are not P.P.&E.-intensive will be more severely impacted by the G.I.L.T.I. regime. Further, Illustration 1 demonstrates that the G.I.L.T.I. regime does not incentivize U.S. businesses to manufacture in the U.S.

## COMPONENTS OF THE F.D.I.I. PROVISION

### 11. What is F.D.I.I.?

F.D.I.I. is the portion of a U.S. corporation's intangible income derived from serving foreign markets, determined by a formula. The F.D.I.I. of any U.S. corporation is the amount that bears the same ratio to the "deemed intangible income" of the corporation as (i) the "foreign-derived deduction eligible income" of the corporation bears to (ii) the "deduction eligible income" of the corporation. The F.D.I.I. formula may be expressed as follows:

$$\text{F.D.I.I.} = \text{Deemed Intangible Income} \times \text{Foreign-Derived Deduction Eligible Income} \div \text{Deduction Eligible Income}$$

> *"The deduction for F.D.I.I. is a deduction of a U.S. corporation, and does not depend on whether the U.S. corporation's foreign income is earned through a C.F.C."*

Three new terms must be defined to properly apply the formula: (i) deemed intangible income, (ii) deduction eligible income, and (iii) foreign-derived deduction eligible income. The concepts are not very different from those discussed above for G.I.L.T.I., except that they are applied in a domestic context and the computations are designed from the basis of a deduction for a U.S. corporation rather than an amount of otherwise deferrable earnings of a C.F.C. that must be included in U.S. income. Stated differently, it is important to note that the deduction for F.D.I.I. is a deduction of a U.S. corporation, and does not depend on whether the U.S. corporation's foreign income is earned through a C.F.C.

*Deemed Intangible Income*

Deemed intangible income of a U.S. corporation is the excess of its (i) deduction eligible income over (ii) deemed tangible income return. The deemed tangible income return is, with respect to any corporation, an amount equal to 10% of the domestic corporation's Q.B.A.I, except that the term "deduction eligible income" is substituted for "tested income" and without regard to whether the corporation is a C.F.C. This may be expressed in the following formula:

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - (0.1 \times \text{Q.B.A.I.})$$

*Q.B.A.I.*

A domestic corporation's Q.B.A.I. is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the tax year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is allowable under Code §167. The adjusted basis in any property must be determined using the alternative depreciation system under Code §168(g), notwithstanding any provision of law enacted after this provision. Use of this depreciation method increases the basis in Q.B.A.I. at any point in time because the useful lives of assets are greater than the useful lives used when depreciation is computed under Code §167.

Specified tangible property means any tangible property used in the production of deduction eligible income. If such property is dual-use property that is used in the production of deduction eligible income and other income, the property is treated as specified tangible property in the same proportion that the deduction eligible gross income produced with respect to the property bears to the total gross income produced with respect to the property. This may be expressed in the following formula:

$$\text{Q.B.A.I. from Dual-Use Property} = \text{Average Adjusted Bases in Specified Tangible Property} \times \text{Deduction Eligible Gross Income Produced with Respect to the Property} \div \text{Total Gross Income Produced with Respect to the Property}$$

The demand for cost segregation studies by U.S. companies manufacturing for export is expected to be quite high, as assets must be matched with revenues derived by the U.S. corporation. It is not likely that the required tracking can be achieved without a cost segregation study.

*Deduction Eligible Income*

Deduction eligible income is, with respect to any U.S. corporation, the excess of (i) gross income of the corporation, excluding specified exceptions, over (ii) allocable deductions (including taxes). It may be expressed in the following formula:

$$\text{Deduction Eligible Income} = \text{Gross income} - \text{Exceptions} - \text{Allocable Deductions}$$

*Exceptions to Gross Income*

The exceptions from the U.S. corporation's gross income when computing F.D.I.I. are as follows:

- Subpart F income
- G.I.L.T.I.
- Certain financial services income, as defined in Code §904(d)(2)(D), relating to the active conduct of a banking, insurance, financing, or similar business
- Any dividend received from a C.F.C. with respect to which the U.S. corporation is a U.S. Shareholder
- Certain domestic oil and gas extraction income
- Any foreign branch income as defined in Code §904(d)(2)(J)

*Foreign-Derived Deduction Eligible Income*

Foreign-derived deduction eligible income is, with respect to any taxpayer for its tax year, any deduction eligible income (*i.e.*, gross income, reduced by exceptions and allocable deductions) derived in connection with (i) property that is sold by the taxpayer to any person who is not a U.S. person and that is established to be for foreign use or (ii) services provided by the taxpayer that are established to be provided to any person not located in the U.S. or with respect to property not located in the U.S.

The I.R.S. is given broad discretion in determining whether the taxpayer has met its burden of proof in establishing that property has been sold for use outside the U.S. or services have been performed for persons or with regard to property located outside the U.S. The terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Foreign use means any use, consumption, or disposition outside the U.S.

Property sold to another person (other than a related party, as discussed below) for further manufacture or other modification in the U.S. is not treated as sold for a foreign use, even if the other person subsequently uses the property for foreign use. Similarly, services provided to another person (other than a related party, as discussed below) located in the U.S. do not generate foreign-derived deduction eligible income even if that other person uses the services in providing services generating foreign-derived deduction eligible income for itself.

If property is sold to a foreign related party, the sale is not treated as for a foreign use, unless the property is ultimately sold by the foreign related party to another person who is unrelated and foreign, and the taxpayer establishes to the satisfaction of the I.R.S. that the property is for foreign use. Similarly, if a service is provided to a related party who is not located in the U.S., the service is not treated as provided for persons or with regard to property located outside the U.S., unless the taxpayer establishes to the satisfaction the I.R.S. that the service is not substantially similar to services provided by the related party to persons located in the U.S.

For this purpose, a related party means any member of an affiliated group of corporations within the meaning of Code §1504(a), with certain adjustments. The adjustments are that a 50%-ownership standard is used, instead of the 80% standard under of Code §1504(a), and insurance companies and foreign corporations are not excluded. In addition, business entities other than corporations can be treated as persons related to a corporation within a group if they are controlled by, or control, a second corporation that is a related person to the first. For this purpose, Code §954(d)(3) concepts of control apply. As a result, ownership, directly or indirectly, of more than 50% (by value) of the beneficial interests in a business entity such as a partnership, trust, or estate could cause that entity to be controlled by a related corporation.

### *Deemed Intangible Income*

A domestic corporation's deemed intangible income means the excess (if any) of its deduction eligible income over its deemed tangible income return. The deemed tangible income return means, with respect to any corporation, an amount equal to 10% of the corporation's F.D.I.I. Q.B.A.I.

In broad terms, F.D.I.I. Q.B.A.I. is computed in a manner that is similar to Q.B.A.I., but with a focus on assets used in the production of deduction eligible income. Again, an asset segregation study will be required to demonstrate classes of income related to the use of the property. If property is dual-use property, the portion that is considered F.D.I.I. Q.B.A.I. is based on the relationship between deduction eligible gross income and total gross income produced with respect to the property. Deemed intangible income can be calculated as follows:

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - (0.1 \times \text{Q.B.A.I.})$$

The deemed intangible income is eligible for the deduction described below.

*Illustration 3*

To illustrate how the computation works, assume that Corp. C is a corporation that is tax resident in a member country of the European Union. Corp. C is engaged in the dairy business. Its global sales are expanding, and for that reason, its U.S. subsidiary, Corp. D, is tasked to build a cheese production plant in the U.S. The output of the plant is sold to unrelated distributors in the U.S. and other places. For the tax year in issue, domestic sales make up 50% of the sales volume and foreign sales make up the balance.

In this example

- intercompany license fees for use of knowhow are ignored,
- state and local taxes are ignored,
- there are no exceptions to gross income for purposes of computing F.D.I.I.,
- the cheese sold for export is identical in all respects to the cheese sold in-country, and
- the price per unit sold is the same for export sales and in-country sales.

The Form 1120 prepared by Corp. D reports the following:

| | |
|---|---|
| • Gross income from: | |
| ○ Export sales of domestically produced cheese | $100X |
| ○ In-country sales of domestically produced cheese | 100X |
| ○ Total gross income | $200X |
| • Operating expenses related to: | |
| ○ Export sales of domestically produced cheese | $30X |
| ○ In-country sales of domestically produced cheese | 30X |
| ○ Total expenses | $60X |
| • G&A expenses | $12x |
| • Income before tax | $128X |

Assume further that the average adjusted basis in P.P.&E. at the cheese production plant is $90X.

The relevant computations are as follows, possibly subject to modification when final regulations are issued by the I.R.S.:

- The deduction eligible income of Corp. D is $128X (*i.e.*, gross income ($200X) – exceptions ($0) – allocable deductions ($72X)).

- The foreign-derived deduction eligible income is $64 (*i.e.*, deduction eligible income derived in connection with property that is sold to any person (here unrelated) who is not a U.S. person for use outside the U.S.).
- The Q.B.A.I. is $90X, and 10% of Q.B.A.I. is $9X.
- The deemed intangible income is $119X (*i.e.*, the excess of foreign-derived deduction eligible income ($128X) over 10% of Q.B.A.I. ($9X)).
- The F.D.I.I. is $59.5X (*i.e.*, deemed intangible income multiplied by the percentage of the deduction eligible income that is foreign-derived (50%)).

Once the amount of the F.D.I.I. is determined for Corp. D, it is entitled to a statutory deduction that reduces the tax rate to an attractive percentage. This statutory deduction is discussed below in conjunction with a comparable deduction for G.I.L.T.I.

Corp. D's U.S. Federal income tax is the sum of the regular tax of 21% on $64X of income from domestic sales plus the reduced tax on foreign derived deduction eligible income, or $13.44X plus the amount $7.81X, which is $21.25X in the aggregate. On these facts, the effective rate of U.S. Federal income tax on total taxable income is 16.6%.

*Illustration 4*

Assume that Corp. E is a domestic corporation that is engaged in the business of providing software engineering solutions for customers. Corp. E's customers are in the U.S. and Europe. Corp. E's only office is in the U.S. When it is retained to perform projects, it regularly relies on independent contractors to work on those projects. These contractors may be based inside or outside the U.S. They provide services to many different customers, and their location does not affect the choice of jobs they receive.

In this example, it is assumed that none of the independent contractors (i) is classified as an employee under standards used in the U.S. and abroad, or (ii) constitutes a branch in the country where the individual is located. Corp. E has no P.P.&E. reported on its tax balance sheet.

Further, in this example

- state and local taxes are ignored, and
- there are no exceptions to gross income for purposes of computing F.D.I.I.

The Form 1120 prepared by Corp. E reports the following:

| | | |
|---|---|---|
| • Gross income from: | | |
| ○ | Service fees derived from customers abroad | $100X |
| ○ | Service fees derived from customers in the U.S. | 100X |
| ○ | Total gross income | $200X |
| • Operating expenses related to: | | |
| ○ | Projects for foreign customers | $30X |
| ○ | Projects for U.S. customers | 30X |

| | |
|---|---|
| ○ Total operating expenses | $60X |

| | |
|---|---|
| • G&A expenses | $12x |
| • Income before tax | $128X |

The relevant computations are as follows, possibly subject to modification when final regulations are issued by the I.R.S.:

- The deduction eligible income of Corp. E is $128X (*i.e.*, gross income ($200X) – exceptions ($0) – allocable deductions ($72X)).
- The foreign-derived deduction eligible income is $64X (*i.e.*, deduction eligible income derived in connection with property that is sold to any person (here unrelated) who is not a U.S. person for use outside the U.S.).
- The Q.B.A.I. is $0.
- The deemed intangible income is $128X (*i.e.*, the excess of deduction eligible income ($128X) over Q.B.A.I. ($0)).
- The F.D.I.I. is $64X (deemed intangible income multiplied by the percentage of the deduction eligible income that is foreign-derived (50%)).

Once the amount of the F.D.I.I. is determined for Corp. E, it is entitled to a statutory deduction that reduces the tax rate to an attractive percentage. This statutory deduction is discussed below in conjunction with a comparable deduction for G.I.L.T.I.

Corp. E's U.S. Federal income tax is the sum of the regular tax of 21% on $64X of income from domestic sales plus the reduced tax on foreign derived deduction eligible income, or $13.44 plus the amount $8.4X, which is $21.88X in the aggregate. On these facts, the effective rate of U.S. Federal income tax on total taxable income is 17.06%.

## COMPONENTS OF THE DEDUCTION SYSTEM FOR G.I.L.T.I. AND F.D.I.I. DERIVED BY CORPORATIONS

### 12. How do the statutory deductions work when a corporation includes G.I.L.T.I. in income or can demonstrate that it has F.D.I.I.?

Code §250 provides that a U.S. corporation is allowed notional deductions when computing taxable income under the F.D.I.I. and G.I.L.T.I provisions of U.S. tax law. The intent is to create a target amount of tax that is substantially less than the 21% corporate tax rate.

Thus, for a taxable year beginning after 2017 and before 2026, a U.S. domestic corporation may deduct (i) 37.5% of its F.D.I.I. and (ii) 50% of its G.I.L.T.I. In light of the 21% corporate income tax, the effective U.S. tax rates are 13.125% on F.D.I.I. and 10.5% on G.I.L.T.I. The effective rate of tax on F.D.I.I. is described above in the illustration of the F.D.I.I. computation.

For tax years beginning after December 31, 2025, the deduction is reduced to (i) 21.875% of F.D.I.I. and 37.5% of G.I.L.T.I. Assuming the 21% corporate income tax remains, the post-2025 effective U.S. rates are 16.406% on F.D.I.I. and 13.125% on G.I.L.T.I.

The amount of the deduction is capped by the domestic corporation's taxable income for the year. Consequently, if, in any tax year, a U.S. corporation's F.D.I.I. and G.I.L.T.I. amounts exceed its taxable income, the deduction is reduced so that it cannot produce a loss.

### 13. Regarding G.I.L.T.I, how is the overall effective rate of foreign and U.S. taxes affected by the 80% cap on creditable foreign income taxes?

In many instances, the combination of a 21% corporate tax rate, a deduction of 50% of the G.I.L.T.I, and the deemed-paid credit capped at 80% of creditable foreign income taxes increases the combined effective rate of foreign and U.S. income tax to 13.125% or more, depending on the tax rate abroad. Because only 80% of foreign tax credits are allowed to offset U.S. tax on G.I.L.T.I., the minimum foreign effective tax rate at which no U.S. residual tax is owed by a domestic corporation with respect to G.I.L.T.I must be increased so that 80% of the foreign rate equals 10.5%. Thus, the U.S. tax is completely eliminated without mathematical slippage when the foreign tax rate 13.125%, as determined by the following formula:

***"For domestic corporations in taxable years beginning after 2025, . . . the minimum foreign tax rate, with respect to G.I.L.T.I., at which no U.S. residual tax is owed is 16.4%."***

$$10.5\% \div (0.8 \times \text{Creditable Foreign Income Tax}) = 13.125\%$$

If the effective foreign income tax rate on G.I.L.T.I. is zero, the U.S. residual tax rate on G.I.L.T.I is 10.5%. As effective foreign income tax rates on G.I.L.T.I. increase from 0% to 13.125%, the total combined foreign and U.S. tax rate on G.I.L.T.I. ranges between 10.5% and 13.125%. If the foreign tax exceeds 13.125%, the credits cannot be used as there is no carryforward of unused foreign tax credits in connection with a G.I.L.T.I. inclusion.

For domestic corporations in taxable years beginning after 2025, the effective tax rate on F.D.I.I. is 16.406% and the effective U.S. tax rate on G.I.L.T.I. is 13.125%. Using the same formula as above, but adjusting the rate of tax, the minimum foreign tax rate, with respect to G.I.L.T.I, at which no U.S. residual tax is owed is 16.4%.

As discussed above, the G.I.L.T.I. computation is not taxpayer friendly. Only 80% of the foreign income taxes allocable to G.I.L.T.I. can reduce the U.S. tax on G.I.L.T.I. As a result, foreign taxes offset U.S. taxes in the ratio of 1.25 foreign tax credits to 1.00 U.S. taxes. In addition, because G.I.L.T.I. is a theoretical concept that simply applies to a percentage of income in excess of a base amount and is placed in a separate foreign tax credit limitation basket, it will likely not be unusual for foreign taxes imposed at rates in ex-cess of 10. 5% to be sucked into the G.I.L.T.I. basket. To the extent that foreign tax is imposed on G.I.L.T.I. at a rate in excess of 13.125%, no benefit will be obtained from the foreign tax credit in the G.I.L.T.I. limitation basket. More importantly, such unused foreign tax credits cannot be carried forward or back and are removed from the general limitation basket. Such unused credits are lost, absolutely.

### 14. When is the deduction for F.D.I.I. and G.I.L.T.I. first effective?

The deduction for F.D.I.I. and G.I.L.T.I. is effective for tax years beginning after December 31, 2017.

## INITIAL PLANNING OPPORTUNITIES

Initial planning opportunities that have been discussed in presentations in the period since the G.I.L.T.I. provisions were first announced include the following:

- Increase Q.B.A.I. to lower G.I.L.T.I. Remember that G.I.L.T.I. is defined as the excess of (i) the U.S. Shareholder's net C.F.C. tested income for the shareholder's tax year over (ii) the C.F.C. net deemed tangible income return. If tangible assets are increased, the return on tangible assets is increased. Whether this alternative is appropriate for a U.S. corporation will depend on the tax rate overseas and the size of the investment constituting Q.B.A.I. Presumably, it will work best for Q.B.A.I. located in no-tax or low-tax jurisdictions that cannot use the foreign tax credit to reduce the tax on the G.I.L.T.I.

- Elect Code §338 treatment when entering a stock purchase agreement regarding a foreign target corporation. Code §338 allows an acquiring corporation to treat stock sales as asset sales. In this way, the election can trigger an increase Q.B.A.I. and a reduction in the G.I.L.T.I. inclusion. The same would be true for a "check-the-box" election that is made effective as of the date of a stock purchase.

- Where a U.S. Shareholder of a C.F.C. is an individual, a Code §962 election may be appropriate. Under this election, the individual's tax on G.I.L.T.I. would be computed as if the C.F.C. were held by a corporation. While G.I.L.T.I. does not give rise to Subpart F income, it is treated in the same way as Subpart F income for various Code provisions, including Code §962.

- Where a U.S. Shareholder of C.F.C. is an individual who does not wish to make an election under Code §962, formation of a U.S. holding company might be appropriate, subject to tax issues that may arise under the personal holding company tax and accumulated earnings tax provisions of U.S. tax law. Those concerns suggest that the choice of making an election under Code §962 is preferable.

- Some state and local taxing jurisdictions may exclude Subpart F income from the state and local tax base. If the exclusion is not extended to the G.I.L.T.I. inclusion, taxpayers may be subject to state and local taxes on G.I.L.T.I. Taxpayers may consider doing business in states that address the different treatment of Subpart F and G.I.L.T.I., or states in which G.I.L.T.I. will otherwise not be included in the tax base.

## CONCLUSION

The enactment of the 2017 Tax Cuts and Jobs Act, U.S. tax law for international operations has introduced changes that are as far reaching as the introduction of Subpart F in 1962. It apparently did so in a matter of two months. Nonetheless, its effect on tax planning will likely touch every U.S.-based corporation participating in global operations. The G.I.L.T.I. income inclusion for all and the corporate deductions for G.I.L.T.I. and F.D.I.I. are two important parts of the Act. This article is a first step in understanding how the new rules work. Prompt final guidance from the I.R.S. on the methodology that will be applied in computing the G.I.L.T.I. inclusion and the related foreign tax credit will be helpful.

# MODIFICATIONS TO THE FOREIGN TAX CREDIT SYSTEM UNDER THE TAX CUTS AND JOBS ACT

**Authors**
Neha Rastogi
Stanley C. Ruchelman

**Tags**
D.R.D.
Foreign Tax Credit
Interest Expense
T.C.J.A.

## INTRODUCTION

One of the principal revisions to U.S. tax law made by the Tax Cuts and Jobs Act ("T.C.J.A.") involves the way U.S. tax law avoids double taxation when a foreign subsidiary distributes a dividend to a U.S. corporation owning shares representing 10% or more of the voting power in the foreign corporation. This article discusses and compares the foreign tax credit ("F.T.C") under prior law with the dividends received deduction ("D.R.D."). Other relevant provisions of U.S. law have been revised, as well. These include the source of income from the production and sale of inventory and the method of apportioning interest expense between domestic and foreign-source income, and the establishment of a separate foreign tax credit limitation basket for branch income. The new provisions are effective for taxable years beginning after December 31, 2017.

## DEEMED-PAID F.T.C. AND SUBPART F INCOME

### Law Prior to T.C.J.A.

A U.S. corporate shareholder that owned 10% or more of the voting stock of a foreign corporation was deemed to have paid a portion of the foreign corporation's taxes at the time it received a dividend from that foreign corporation. In computing its U.S. tax liability, the U.S. corporate shareholder was allowed a credit of the foreign taxes deemed to have been paid.[1] The amount of this deemed-paid credit was treated as additional dividend income, thereby equating the treatment to a foreign branch of a U.S. corporation, by treating the U.S. company as if it derived gross income on a pre-tax basis.[2]

### New Law

The T.C.J.A. adopts the D.R.D. method of eliminating double taxation on dividend income from foreign subsidiaries. First, it partially repeals the deemed-paid F.T.C. provisions, thereby disallowing the credit for foreign taxes paid by the foreign corporation on income distributed to its U.S. corporate shareholders.[3] Second, the T.C.J.A. introduces the D.R.D. system, provided that certain ownership hurdles are met.[4] As a result, 100% of the foreign-source portion of dividends received from a specified 10%-owned foreign corporation by a U.S corporate shareholder is exempt from U.S. taxation.

---

1 Code §902 as in effect prior to T.C.J.A.

2 Code §78.

3 Section 14301 of the T.C.J.A.

4 Section 14101 of the T.C.J.A. inserted a new Code §245A.

Note that this is a Canadian-style D.R.D., rather than a European-style participation exemption, in that capital gains from the sale of shares of a specified 10%-owned foreign corporation remain subject to tax in the U.S. However, the portion of the gain that is attributable to retained earnings and converted into dividend income under Code §1248 now benefits from the D.R.D.

A similar D.R.D. regime is available to a corporate shareholder that receives dividends from a domestic corporation. A 50% D.R.D. is allowed for corporate recipients that own less than 20% of the domestic corporation. A 65% D.R.D. deduction is allowed to corporate recipients that own 20% or more of the domestic corporation. However, a 100% deduction is allowed only when dividends are received from affiliated corporations.[5]

The new law retains the deemed-paid F.T.C. provisions under Code §960 but in modified form. Code §960 provides a deemed-paid credit for Subpart F inclusions for U.S. corporations that are "U.S. Shareholders" of a controlled foreign corporation ("C.F.C."). The allowable credit under Code §960 is based on current-year taxes rather than the Code §902 "pooling" approach under prior law.[6] Pooling is no longer required because the inclusion of earnings under Code §951A, as of the last taxable year beginning before 2018, will harvest those earning for income tax purposes.

***"The portion of the gain that is attributable to retained earnings and converted into dividend income under Code §1248 now benefits from the D.R.D."***

In addition, the deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the Subpart F inclusion from a particular C.F.C. This rule is intended to prevent a taxpayer from managing its foreign taxes to benefit from the D.R.D and F.T.C. regimes by blending high-tax domestic income with low-tax Subpart F income.

The I.R.S. is authorized to issue legislative regulations that carry out the purpose of the new law. Although not mentioned in the legislative history, one area that should be addressed by the I.R.S. involves a unified tax base in a foreign country and a C.F.C. that has losses not related to Subpart F income that reduces the taxes attributable to Subpart F income. Presumably, some form of adjustment in taxes should be made. How this will be done is not clear at this time. One way would be to allow the non-Subpart F losses to reduce the amount of Subpart F income. If that were done, the tax benefit of the Subpart F reduction likely would be recaptured by recharacterizing non-Subpart F income in future years to claw back the benefit.

## SOURCE OF INCOME FROM A SALE OF INVENTORY

### Law Prior to the T.C.J.A.

Income from the sale of inventory property that a taxpayer produced (in whole or in part) in the U.S. and sold outside the U.S., or that a taxpayer produced (in whole or in part) outside the U.S. and sold in the U.S., is treated as partly U.S.-source and partly foreign-source.[7] A taxpayer could elect one of three methods for allocating and apportioning income between sources in the U.S. and sources abroad:

[5] Code §243.

[6] Section 14301 of the T.C.J.A.

[7] Code §863(b); Treas. Reg. §1.863-3.

- *The 50-50 Method.* Under this method, 50% of the income from the sale of inventory property was considered to be attributable to the production activities and 50% to the sales activities. Income was sourced based on the location of those activities.

- *The Independent Factory Price ("I.F.P.") Method.* Under this method, if an I.F.P. was established by a taxpayer, it was used to determine income from production activities. The balance of the income was sourced under rules for sales of inventory, generally at the place where title passed.

- *The Books and Records Method.* This method was applied only with advance permission of the I.R.S. Once permission was obtained, the taxpayer was permitted to rely on its books of account to detail the allocation of receipts and expenditures between production and sales activities.

In determining the source of income apportioned to production activity, the place or places of production controlled the source. Where more than one facility was used in more than one country, the source of the production activity was apportioned to those places, which could be (i) entirely within the U.S., (ii) entirely outside the U.S., or (iii) a mixture of both.

### New Law

The T.C.J.A. sources the income from the sale of inventory entirely based on the place of production. Thus, the income will be entirely U.S. source if the inventory property is wholly produced in the U.S., irrespective of the place of sale.[8] Similarly, income derived from inventory property sold in the U.S. but produced entirely in another country is sourced in that country, even if title passage occurs in the U.S. If the inventory property is produced partly within and partly without the U.S., income from the sales would be partly U.S. source and partly foreign source.

Interestingly, in foreign countries, the new source rule for the sale of inventory reflects a policy that focuses on the place of consumption for digital products.

## INTEREST EXPENSE ALLOCATION

### Law Prior to the T.C.J.A.

The F.T.C. available to offset U.S. tax has traditionally been limited to the portion of the U.S. tax that is imposed on foreign-source taxable income.

Foreign-source taxable income is determined in two steps: The first step involves the determination of the source of gross income. The second step involves the allocation and apportionment of expenses, including, *inter alia*, interest expense.

Under prior law, the allocation and apportionment of interest expense were made on the basis of assets.[9] Three methods were available to apportion interest expense:

- *Tax Book Value Method.*[10] This method used the tax book value of assets to

---

8 Code §863(b) as amended by Section 14303 of T.C.J.A.

9 Code §864(e)(2).

10 Treas. Reg. §1.861T-(g)(2).

apportion interest expense between domestic- and foreign-source income.

- *Alternative Tax Book Value Method.*[11] Over time, the tax book value method apportioned excessive interest expense to assets producing foreign-source income simply because depreciable assets located abroad use longer lives to compute depreciation.[12] Consequently, taxpayers were permitted to use a method that adjusted for the distortion in values between domestic and foreign assets.

- *Fair Market Value Method.*[13] Under this method, the taxpayer performed a hypothetical valuation of its assets first by arriving at a market capitalization, if it was publicly traded, or by an enterprise value determined through a capitalization of its earnings. Debt held by unrelated parties was added to this value. Tangible assets of each foreign and domestic member of the group were valued and that value was subtracted from the enterprise value. The remainder was the value of the intangible assets. That value was apportioned to all companies based on relative adjusted net income. The value of the assets of each company in the U.S. and abroad was equal to (i) the sum of the values of that company's tangible and intangible assets, reduced by (ii) that company's debt. This method reached apportionment values that are viewed to be unreliable, especially for companies that hold intangible assets.

## New Law

The T.C.J.A. prohibits members of a U.S. affiliated group from allocating interest expense on the basis of the fair market value of assets. Instead, the members are now required to allocate interest expense based on the adjusted tax basis of the assets. As under prior law, the F.T.C. will continue to be limited to the portion of the U.S. tax that is imposed on foreign-source taxable income.

Currently, Code §864(e) provides for the allocation and apportionment of interest expense by members of an affiliated group. The interest expense apportioned to non-U.S. members of the affiliated group is not taken into account when apportioning interest expense of group members between U.S. and foreign-source income. As a result, this may cause an over-allocation of interest expense to foreign-source income, thereby reducing foreign-source taxable income and limiting the F.T.C.

## Provisions Not Yet in Effect

The Senate proposed to accelerate the effective date of Code §864(f), which is currently scheduled to take effect from January 1, 2021, to impact tax years beginning after December 31, 2017. Although Congress did not include the Senate's recommendation in the T.C.J.A., the interest expense allocation calculation under Code §864(f), as opposed to the current method, is worth mentioning.

Code §864(f) permits U.S. members of a U.S.-based worldwide affiliated group to elect to allocate and apportion interest and other expenses on a worldwide basis. A result is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the

---

[11] Treas. Reg. §1.861-9(i).

[12] Code §168(g)(1)(A).

[13] Treas. Reg. §1.861-9T(i).

domestic members must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The rules under Code §864(f) are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

To illustrate, take the following example:

| Turnover/Gross Receipts | U.S. Affiliate | Foreign Affiliate | Total |
|---|---|---|---|
| U.S. Assets<br>(adjusted basis in light of new amendment) | $1000 | $500 | $1,500 |
| Foreign Assets<br>(adjusted basis in light of new amendment) | $500 | $2,000 | $2,500 |
| **Total** | **$1,500** | **$2,500** | **$4,000** |
| **Interest Expense** | **$300** | **$280** | **$580** |

Based on the above facts, the allocation of interest expense under Code §864(f) and Code §864(e) is as follows:

| Application of Code §864(f)<br>(Effective after December 31, 2020) | |
|---|---|
| **Step 1** | |
| Total Interest Expense of U.S. and Foreign Affiliate<br><br>($300 + $280) | $580.00 |
| **Step 2** | |
| Interest Expense Allocable to Foreign-Source Income Within the Entire Group (*i.e.*, U.S. and Foreign Affiliate)<br><br>[$580 x ($2,500/$4,000)] | $362.50 |
| **Step 3** | |
| Interest Expense Allocable to Foreign-Source Income of the Foreign Members<br><br>[$280 x ($2,000/$2,500)] | $224.00 |
| **Step 4** | |
| Interest Expense Allocable to Foreign-Source Income of the U.S. Affiliate<br><br>($362.50 - $224) | $138.50 |

| Foreign Affiliate<br>Total | |
|---|---|
| **Step 1** | |
| Interest Expense of the U.S. Affiliate | $300.00 |
| **Step 2** | |
| Interest Expense Allocable to Foreign-Source Income of the U.S. Affiliate<br><br>[$300 x ($500/$1,500)] | $100.00 |

The foregoing illustrates that the U.S. affiliate is more highly leveraged than the foreign affiliate. Consequently, the portion of the U.S. company's interest expense that is allocated to foreign-source income would increase when the apportionment of interest expense is computed on a global basis.

## F.T.C. LIMITATION BASKET FOR FOREIGN BRANCH INCOME

### Law Prior to the T.C.J.A.

As mentioned above, the F.T.C. that is available to offset U.S. tax will continue to be limited to the portion of the U.S. tax that is imposed on foreign-source taxable income. This is known as the F.T.C. limitation. The F.T.C. limitation is applied separately to (i) investment income and (ii) all other income.[14] This is intended to prevent income that is subject to relatively lower tax – typically investment income from foreign sources – from being used to absorb credits on highly-taxed income that would otherwise exceed the limitation.

***"It favors outbound investments – something Congress intended to curb."***

### New Law

A new F.T.C. limitation basket for foreign branch income has been introduced by the T.C.J.A.[15] Under the provision, foreign branch income is a U.S. person's business profits attributable to one or more qualified business units ("Q.B.U.'s") in one or more countries.[16] Generally, a Q.B.U. is defined in Code §989 as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."

## CONSEQUENCES

The introduction of a 100% D.R.D. for dividends received from a foreign corporation held 10% or more by U.S. persons may result in an outcome not intended by Congress. Unlike dividends received from foreign corporations, dividends received from a domestic corporation are only fully deductible for a more than 80% shareholder. Thus, while a U.S. corporate shareholder who owns 10% of a foreign corporation and 10% of a domestic corporation will be able to enjoy a 100% D.R.D. with respect to the foreign corporation, only a 50% D.R.D. could be claimed with respect to the domestic corporation. This outcome may be unintentional, but it could have enormous consequences since it favors outbound investments – something Congress intended to curb.

---

[14] Code §904(d).

[15] Section 14302 of T.C.J.A.

[16] Code §904(d)(2)(J) as inserted by section 14302 of T.C.J.A.

# TAX CUTS AND JOBS ACT ADOPT PROVISIONS TO PREVENT BASE EROSION

**Authors**
Sheryl Shah
Stanley C. Ruchelman

**Tags**
B.E.P.S.
Code §163(j)
Hybrid Mismatch
G.I.L.T.I.
Grecian Magnestie
Outbound Transfers
Partnership
Subpart F
T.C.J.A.

## INTRODUCTION

Following the lead of the O.E.C.D. and the European Commission ("E.C."), the Tax Cuts and Jobs Act ("T.C.J.A.") adopts several provisions designed to end certain tax planning opportunities. Provisions such as these are often described as attacks on base erosion and profit shifting. In bygone days, the targeted plans were known as innovative. Now, they are characterized as abusive.

In some instances, the T.C.J.A. closely follows counterpart provisions recommended by the O.E.C.D. and adopted by the E.C. In others, the provisions that are specific to U.S. tax law.

## GLOBAL INTANGIBLE LOW-TAX INCOME

With the adoption of a dividends received deduction ("D.R.D."), the T.C.J.A. embraces a provision that prevents large U.S.-based groups from reducing U.S. tax through base eroding payments only to have these payments return to the U.S. in a tax-free manner under the D.R.D. The new Code §951A imposes a claw-back tax on U.S. corporations that make tax reducing payments to controlled foreign corporations ("C.F.C.'s"). The receipt of those payments leads the item to be included in the gross income of the C.F.C.'s "U.S. Shareholder," as defined under **Broadened Scope of Subpart F** below, as Global Intangible Low-Tax Income ("G.I.L.T.I."), to the extent a base amount is exceeded.[1] The base amount equals 10% of the taxpayer's Qualified Business Asset Investment. The inclusion is taxed at a special low rate of 10.5%, with a foreign tax credit allowed – albeit capped at 80% of the G.I.L.T.I. This ensures that a tax of at least 10.5% will be paid on the income, and if tax is imposed abroad, a global tax of 13.5% will generally be paid.

## REVISION TO LIMITATIONS ON INTEREST EXPENSE DEDUCTIONS UNDER CODE §163(J)

### Prior Law

Provisions designed to prevent "earnings stripping" were first adopted by the U.S. when Code §163(j) was adopted in 1989. Its goal was to prevent erosion of the U.S. tax base through excessive deductions for interest paid by a taxable corporation to a related party that was not fully taxed in the U.S. on the receipt of the income.

Under prior law, the provision disallowed a deduction for "disqualified interest" paid

---

1 The G.I.L.T.I. provision is discussed in greater detail in this edition of Insights in "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?"

or accrued by a corporation in a taxable year if two threshold tests were satisfied. First, the payor's debt-to-equity ratio exceeded 1.5 to 1.0. Second, the payor's net interest expense exceeded 50% of its adjusted taxable income, generally, E.B.I.T.D.A. (earnings before interest, taxes, deprecation, and amortization) with certain adjustments for tax concepts.

Disqualified interest included, *inter alia*, interest paid or accrued to (i) related parties outside the U.S. that were not subject to full withholding tax and (ii) unrelated parties when the obligation was guaranteed or supported by a related party. Interest expense deductions disallowed under these rules could be carried forward indefinitely, and any excess limitation could be carried forward for three years.

## T.C.J.A.

The T.C.J.A. expands the scope of Code §163(j) so that it is no longer a provision designed to prevent base erosion through payments to related parties. It is now a provision designed to limit the use of debt to fund the acquisition of business assets and the operation of a business in the U.S.

For taxable years beginning after 2017, the deduction for business interest is limited to the sum of

- business interest income,
- 30% of the adjusted taxable income of the taxpayer for the taxable year, and
- floor plan financing[2] interest on loans used to finance the acquisition of motor vehicles.

For taxable years beginning after December 31, 2017, and before January 1, 2022, adjusted taxable income is generally computed as under prior law.[3] Thereafter, adjusted taxable income is generally equivalent to E.B.I.T. At that point, depreciation, amortization, and depletion will no longer be added back to income for purposes of determining the base on which the 30% cap is computed.

The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely, subject to certain restrictions applicable to partnerships.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Code is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment

---

[2] "Floor plan financing" is a type of short-term loan used by retailers to purchase high-cost inventory such as automobiles. These loans are often secured by the inventory purchased as collateral.

[3] One of the adjustments under current law is the deduction under Code §199 for domestic production activities. This deduction is eliminated by the T.C.J.A. and is excluded from the adjustments.

income, within the meaning of Code 163(d).[4]

The limitation applies at the taxpayer level. Where a business is carried on through a partnership, including an L.L.C., the partners ignore their respective distributive shares of income, gain, deduction, or loss when calculating adjusted taxable income.[5] However, a partner of a partnership may deduct additional interest expense to the extent the partnership could have deducted more business interest. The additional interest that may be claimed by each partner is computed by a formula.

Certain businesses are not covered by revised Code §163(j). These include the following:

- Taxpayers with average annual gross receipts for a three-taxable-year period, ending with the prior taxable year, that do not exceed $25 million
- A taxpayer in the trade or business of performing services as an employee
- An electing real property trade or business
- An electing farming business
- A taxpayer in the trade or business of furnishing or selling (i) electrical energy, water, or sewage disposal services, (ii) gas or steam through a local distribution system, or (iii) transportation of gas or steam by pipeline, provided that in all such businesses the rates are subject to regulatory approval

## HYBRID TRANSACTIONS AND ENTITIES

### Prior Law

The use of hybrid entities and hybrid transactions has been a staple of U.S. tax planners for many years.

An example of a plan involving a hybrid entity includes royalty or interest payments between C.F.C. subsidiaries in different foreign countries where both subsidiaries make elections to be disregarded entities. If the recipient of the payment is based in a low-tax or no-tax country, the payment may be deductible for the payor, subject to little or no tax for the recipient. At the same time the payment may not be viewed to be Foreign Personal Holding Company Income because it is viewed for U.S. purposes to be an internal transaction within one C.F.C.[6]

An example of a hybrid transaction involves a U.S.-based group with a Luxembourg holding company that issues a contingent participating equity certificate to a group member. In Luxembourg, the payment is treated as interest and is not subject to

---

4 Interest expense incurred of a taxpayer other than a corporation on a borrowing to make an investment is deductible only to the extent of interest income.

5 Similar treatment is applied to S-corporations and their shareholders.

6 Even if the entities do not elect to be treated as disregarded entities for U.S. income tax purposes, the payments may avoid Foreign Personal Holding Company Income characterization by reason of Code §954(c)(6), which characterizes the income of the recipient by reference to the character of the payor's income that is reduced by the payment.

withholding tax. At the same time, the recipient of the payment takes the position that it may treat the payment as a dividend on which a D.R.D. is allowed under local law.[7]

### T.C.J.A.

Two provisions in the T.C.J.A. limit the use of hybrid transactions and entities to reduce tax in a cross-border setting. One is Code §267A, which relates to deductions claimed for hybrid payments,[8] and the other is Code §245A, which relates to the new D.R.D. provision of U.S. tax law.[9]

#### *Code §267A*

A deduction is disallowed for any "disqualified related party amount" that is paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that either of the following are true:

- There is no corresponding inclusion to the related party under the tax law of the country of which the related party is a resident for tax purposes or is subject to tax.
- The related party is allowed a deduction with respect to the amount under the tax law of that country.

*"A hybrid dividend received by a U.S. shareholder from a C.F.C. does not qualify for the D.R.D. . . . A comparable provision applies in the international context."*

A related party for these purposes is determined under the rules of Code §954(d)(3), which is applied to the payor as opposed to the C.F.C.

A hybrid transaction is any transaction, agreement, or instrument involving one or more payments that are treated as interest or royalties for Federal income tax purposes when comparable treatment is not provided to the recipient for purposes of the tax law in its country of residence (or in a country where the recipient is subject to tax).

A hybrid entity is any entity that meets either of the following conditions:

- It is treated as fiscally transparent for Federal income tax purposes but not for purposes of the tax law of the foreign country of residence (or in a country where it is subject to tax)
- It is treated as fiscally transparent, or is subject to tax, for purposes of the tax law of the foreign country of which the entity is resident for tax purposes but is not so treated for Federal income tax purposes.

Under an exception, a disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. Shareholder under Code §951(a).

---

[7] The opportunity for dividend treatment has been curtailed in recent years under the O.E.C.D.'s B.E.P.S. initiative, the multilateral tax convention, and various E.C. directives.

[8] Code §267A.

[9] Code §245A.

*Code §245A*

This section provides that a hybrid dividend received by a U.S. shareholder from a C.F.C. does not qualify for the D.R.D. A hybrid dividend means an amount received from a C.F.C. that would qualify for the deduction under Code §245A except that the C.F.C. distributing the dividend received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the U.S.

A comparable provision applies in the international context when a C.F.C. receives a hybrid dividend from any other C.F.C. and the same U.S. corporation is a U.S. Shareholder of both C.F.C.'s. Where those facts exist, the hybrid dividend is treated as Subpart F income, discussed below, notwithstanding any other provision of the Code. The U.S. Shareholder is taxed on the Subpart F income inclusion.

## BROADENED SCOPE OF SUBPART F

Subpart F is applicable to C.F.C.'s and their U.S. Shareholders, as defined below. It is the principal anti-deferral regime of relevance to a U.S.-based multinational corporate group.

A C.F.C. generally is defined as any foreign corporation in which U.S. Shareholders own (directly, indirectly, or constructively) shares representing more than 50% of the corporation's voting power or value.

Under the Subpart F, U.S. Shareholders of a C.F.C. are taxed on their *pro rata* shares of certain C.F.C. income (referred to as Subpart F income). Subpart F income is included in the income of a U.S. Shareholder automatically. Thus, the taxable event does not require the receipt of a dividend from the C.F.C. Within certain limitations, dividends that are paid by a C.F.C. in the year of an inclusion in income, or a subsequent year, are deemed to come from previously taxed earnings of the C.F.C. This means that Subpart F income is taxed on a priority basis in relation to dividends, and consequently, is not taxed when received.

With exceptions, Subpart F income generally includes passive income – dividends, capital gains, interest, and royalties – and other income that is readily movable from one taxing jurisdiction to another. Examples are foreign base company sales income – generally arising from cross border trading activities involving a related supplier or customer based in a third country – and foreign base company services income – generally income from services performed in third countries for or on behalf of a related party.

Certain rules of attribution applied to treat shares owned by one person as if owned by another. In certain circumstances shares could be attributed from shareholders to a U.S. corporation, from one family member to another, and from trusts to beneficiaries. Also, shares could be attributed from corporations to shareholders, from partnerships to partners, and from partners to partnerships.

### Prior Law

Under prior law, a U.S. Shareholder was a U.S. person that owned shares of the foreign corporation having 10% of the voting power. U.S. persons include U.S. citizens, U.S. residents, U.S. corporations, U.S. domestic trusts or estates, and U.S.

partnerships and L.L.C.'s.

Shares could not be attributed from a nonresident, noncitizen individual to a U.S. citizen or resident. Also, shares could not be attributed from a foreign corporation that is a shareholder to a U.S. corporation.

Congress became aware of a relatively simple method to decontrol a C.F.C. without imposing U.S. tax after a foreign corporation acquires a U.S.-based multinational group with foreign subsidiaries. Rather than sell the subsidiaries, the foreign parent of the U.S.-based group could invest in each of the C.F.C.'s and receive sufficient voting shares to own at least 50% of the voting power of the foreign subsidiaries. Those newly issued shares were not attributed to the U.S.-based group.

In addition, before Subpart F could apply to a C.F.C. and its U.S. Shareholders, a foreign corporation was required to be a C.F.C. for 30 days during the taxable year.

**T.C.J.A.**

Several changes are made to broaden the circumstances in which a U.S. person can be viewed to be a U.S. Shareholder and a foreign corporation can be a C.F.C.

*Change in Definition of "U.S. Shareholder"*

The T.C.J.A. revises the definition of U.S. Shareholder. A U.S. person can now be a U.S. Shareholder if it owns shares representing 10% of the voting power or 10% of the value of the foreign corporation.

*Attribution from Foreign Corporations*

Generally, attribution from a foreign parent of stock in a foreign corporation will occur only when a U.S. person actually owns shares in the foreign corporation.

To address the decontrol issue mentioned above, the law is now changed, so that the newly issued shares can be attributed to the U.S.-based group from the foreign parent. The Conference Committee report states that this change in law is intended to apply primarily to stop the use of decontrol plans. Hence, the focus on attribution when some stock is actually owned by the U.S. corporation.

Under the T.C.J.A., the *pro rata* share of a C.F.C.'s Subpart F income that may be taxed in the hands of a U.S. Shareholder continues to be determined based on direct or indirect ownership of the C.F.C., without application of the new downward attribution rule. In addition, the attribution rules remain unchanged for purposes of determining whether a Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, must be filed by a U.S. person.

*Repeal of the 30-Day Rule*

The T.C.J.A. repeals the 30-day requirement for a foreign corporation to be a C.F.C. in order for Subpart F to apply. Thus, if a foreign person owns all the shares of a foreign corporation, and a U.S. person acquires those shares within the 29-day period ending on the last day of the C.F.C.'s year, Subpart F applies to the U.S. acquirer for that for the days of ownership within the 29-day period. This prevents the foreign corporation from disposing of its assets without U.S. tax during the 29-day period without a potential tax imposed on the U.S. Shareholder.

## CHANGES TO OUTBOUND TRANSFER RULES

### Prior Law

*"The I.R.S. unilaterally attempted to expand the list of intangible property under Code §936."*

Although a U.S. taxpayer generally was not permitted to transfer certain assets to a foreign corporation without recognizing gain,[10] an exception was provided for certain transfers of property for use in an active business conducted abroad.[11] Certain assets were not covered by this exception. These assets included (i) inventory, copyrights, or similar property; (ii) installment obligations, accounts receivable, or similar property; (iii) foreign currency or other property denominated in foreign currency; (iv) intangible property; and (v) property for which the transferor was the lessor at the time of transfer, unless the transferee is the lessee.[12] If the asset transfer was part of the incorporation of a foreign branch that generated losses, gain was required to be recognized in an amount equal to the previously recognized net loss.

A separate rule applied to transfers of intangible property as part of a tax-free transaction.[13] Rather than mandating immediate gain recognition on the transfer, Code §367(d) provided that the transaction would be treated as a sale for contingent consideration based on productivity, use, or disposition of the transferred intangible property. For this purpose, intangible property was defined by reference to Code §936(h). One issue that arose was whether locally developed good will and workforce in place were items of intangible property covered by Code §367(d), as they are not among the listed items specified in Code §936(h).

This provision had many similarities with the buy-in provisions of the qualified cost sharing regulations issued under Code §482, under which related companies in various parts of the world could arrange to share intangible property development costs without the need for cross royalty payments if each participant agreed to bear its proper share of costs based on expected profits.

In recent years, the I.R.S. unilaterally attempted to expand the list of intangible property under Code §936 by asserting that foreign goodwill developed by a foreign branch and the value of a workforce in place were items of intangible property for which compensation would be required on transfer. This position was struck down by courts in *Veritas v. Commr.*[14] and *Amazon v. Commr.*,[15] cases involving qualified cost sharing arrangements. In *Amazon*, the I.R.S. also asserted that, where appropriate, related transfers of intangible property be valued in the aggregate if the value of the whole exceeded the sum of individual values. It also asserted that in determining whether a transaction conducted by related parties was arm's length, realistic alternatives to the chosen form of transaction had to be considered. Both arguments were rejected as inconsistent with the list of intangibles in Code §936. Although the issue was not presented before the court in *Amazon*, the decision implicitly invalidated Treas. Reg. §1.482-7(g)(2)(iv) regarding qualified cost sharing arrangements.

---

10 Code §367(a)(1).

11 Code §3676(a)(2).

12 Code §367(a)(3)(B).

13 Code §367(d).

14 133 T.C. 297 (2009), nonacq., AOD 2010-005, 2010-49 I.R.B. (Dec. 6, 2010).

15 148 T.C. No. 8 (2017).

#### T.C.J.A.

The T.C.J.A. addresses the definitional and methodological issues that arose in the *Veritas* and *Amazon* cases in connection with the definition of intangible property and legislatively reverses the holdings by revising the law as follows:

- Workforce in place, both foreign and domestic goodwill, and going concern value are intangible property within the meaning of Code §936(h)(3)(B).
- Also included in covered intangible property is the residual category of "any similar item," the value of which is not attributable to tangible property or the services of an individual.
- Language at the end of Code §936(h)(3)(B) is removed, to make clear that the source or amount of value is not relevant in determining whether property that is one of the specified types of intangible property is within the scope of the definition.
- The I.R.S. is granted authority to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of U.S. operations and to intercompany pricing allocations. This is done by amending Code §482 and granting regulatory authority to the I.R.S. in Code §367 regarding the use of aggregate basis valuation and the application of the realistic alternative principle.
- The use of the aggregate basis valuation method is required in the case of transfers of multiple intangibles in one or more related transactions if the I.R.S. determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach.
- The use of the realistic alternative principle is codified when determining the transaction value to be used with respect to intangible property transactions. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the chosen transaction.
- Existing regulations under which the I.R.S. may determine an arm's-length price by reference to a transaction that is different from the transaction that was actually completed are ratified.

  Thus, for example, assume Corporation A is the owner of intangible property used to manufacture a widget, and Corporation B is a controlled foreign distributor. Corporation A can choose to manufacture the widget itself, or it can choose to license the intangible property to Corporation C, a related party in a low-tax jurisdiction, which uses the intangible property to manufacture the product for resale to Corporation B. In testing whether the value of the intangible asset transfer from Corporation A to Corporation B is arm's length, the I.R.S. may compare the actual results with those in a hypothetical fact pattern in which Corporation A chooses to manufacture the product itself.

## DISPOSITION OF PARTNERSHIP INTERESTS

A partnership is generally treated as a pass-thru entity, and its items are realized by the partners.[16] A partner is required to include in its income its share of the partnership items even if the item has not been distributed. The partner's basis in its partnership interest is increased and decreased by gains and losses, respectively. A transfer of a partnership interest does not trigger a basis adjustment unless a 754 election is made or there is a substantial built-in loss. Any adjustment made is to account for the difference between the transferee's proportionate share and basis in the interest.

Foreign persons that hold partnership interests are treated as engaged in a U.S. trade or business if the partnership is engaged in a U.S. trade or business because of its asset use or business activities.[17] Consideration received by the foreign person or corporation for its interest in a U.S. real property interest held by a partnership is treated as received in exchange for such property, making it effectively connected with the conduct of a U.S. trade or business.[18]

### Prior Law

There have been conflicting rulings on the source of gain or loss from the sale or exchange of an interest in a foreign partnership engaged in U.S. trade or business.

Despite a contradictory revenue ruling, in *Grecian Magnesite Mining, Industrial & Shipping Co. v. Commr.*,[19] the court ruled that a foreign corporation's gain on the sale of a partnership interest of a partnership engaged in a U.S. trade or business wasn't U.S.-source income or effectively connected with a U.S. trade or business.

### T.C.J.A.

The T.C.J.A. clarifies the confusion on whether gain or loss is effectively connected to certain interests by assuming a complete sale.

- The gain or loss from the sale or exchange of a partnership interest will be treated as effectively connected with a U.S. trade or business to the extent that the transferor would have effectively connected gain or loss had the partnership sold all of its assets on the date of the sale or exchange. Gain or loss is allocated to partnership interests in the same way as non-separately stated income and loss.

- In addition, the transferee is required to withhold 10% of the amount realized unless the transferor can certify it is not a nonresident alien or a foreign corporation. The partnership will deduct and withhold the amount that the transferee fails to.

## CONCLUSION

Many European politicians have questioned whether the U.S. is compliant with the O.E.C.D.'s B.E.P.S. initiative. In light of the revisions to the international provisions of U.S. tax law that are discussed above, the answer appears to be, "Yes, but in

---

16 Code §702.

17 Code §875.

18 Code §897(a) and (g).

19 149 T.C. No. 3(2017).

an American way." Limitations have been placed on interest expense deductions, deductions for hybrid transactions have been eliminated in a deduction/no tax scenario, the scope of the C.F.C. laws has been broadened, and the transfer to foreign subsidiaries of profit-making opportunities can now be challenged through transfer pricing adjustments. Add to this CbC reporting for U.S.-based multinationals and F.A.T.C.A., and the U.S. appears to have followed the O.E.C.D. action plans in a stealth-like way.

# CIRCULAR LETTER NO. 25/E CLARIFIES ITALY'S NEW CARRIED INTEREST REGIME

**Authors**
Andrea Tavecchio
Riccardo Barone

**Tags**
Carried Interest
Italy

Andrea Tavecchio is the founder of Tavecchio Caldara & Associati in Milan, Italy. He is a Chartered Accountant and TEP with experience assisting private clients and families in wealth planning, asset protection, and estate planning. Andrea is member of the Scientific Committee of STEP Italy and has also served on committees on economic and fiscal matters, reporting to the Ministry for Economic Development and the Prime Minister's office.

Riccardo Barone is an associate with Tavecchio Caldara & Associati. He is a Chartered Accountant and holds a Master in Tax Law from the Cattolica University of Milan. Riccardo focuses his practice on international taxation, asset protection, trust and estate planning, and taxation of financial investments.

## INTRODUCTION

On April 24, 2017, the Italian government introduced a new tax regime addressing carried interests and similar arrangements that involve shares, quotas, and other financial instruments. The aim is to boost the Italian private equity and private debt sectors and make Italy more attractive to fund management companies and top executives.

The new regime has been introduced by Law Decree 24 April 2017 No. 50 (the "Decree"),[1] which provides that "qualifying" carried interest schemes are deemed financial income, rather than employment income. Article 60 of the Decree provides an irrebuttable presumption that remuneration derived from certain carried interest schemes qualifies as income from capital, or capital gain, generally subject to only a 26% substitute tax.

On October 16, 2017, the Italian tax authorities released official guidelines, Circular Letter No. 25/E (the "Circular"), that provide significant clarifications on the scope, requirements, and conditions envisaged under the new tax regime.

## CARRIED INTEREST: AN OVERVIEW

Private equity transactions generally require a contract between investors and the fund managers that includes provisions exposing the managers in investment-related risks.

One of these mechanisms is the "carried interest," a compensation incentive that aligns the interests of the fund managers with those of the investor group. This kind of remuneration takes the form of shares, quotas, or financial instruments with "enhanced economic rights," such as

- a shareholding more than proportional to the profits of the investment, or
- the right to convert financial instruments into a more than proportional number of ordinary shares.

This is achieved by tying remuneration to a minimum return for other investors.

## QUESTION OF INCOME CLASSIFICATION

The dual role of the manager as administrator or employee and shareholder has created questions regarding the tax treatment of carried interests. If the income

[1] Converted into Law 21 June 2017, No. 96.

from enhanced equity rights is classified as financial income, the managers may benefit from the flat rate of 26%, as mentioned above. On the other hand, if that income is classified as employment income, it can be taxed at marginal rates up to 43% plus local surcharges and social contributions.

The core issue is that some types of carried interest typically are considered to be performance fees, which fall within the category of employment income if viewed as a bonus for performance. According to Article 51 of the Italian Income Tax Code ("T.U.I.R."), employment income consists of "*all sums and values of whatever nature received during the tax period, . . . , in relation to the employment relationship*." To that end, Ministerial Circular No. 326/1997 clarified that all remunerations related to an employment relationship are properly categorized as employment income "*even if they are not directly paid by the employer*," including "sums and values received in the form of equity shareholding."

One area of concern is where the rules apply to stock options. Pursuant to Italian law, income arising from the exercise of stock options (calculated as the difference between the fair market value of shares purchased and the strike price) is considered employment income. This definition posed problems for managers who benefit from:

- a "preferential" distribution of the company profits or a capital gain realized through the disposal of the company itself, or
- in the case of stock options, the payment of a strike price lower than the market value of the shares.

The similarity between the carried interest and stock options regimes led to uncertainty regarding the treatment of carried interest for income tax purposes.

In 2012, the Italian tax authorities addressed the classification of this kind of compensation in Resolution n. 103. The case concerned the assignment of a disproportionate number of shares to the company's managers compared to their cash investment in the company. The Revenue Agency stated that the non-proportional allocation of the shares to the managers had, in the analyzed case, a remunerative function for their performance. Consequently, the income arising from the share assignment – equal to the difference between the total fair value of the shares assigned to each manager and the amount paid to subscribe them – is to be considered employment income. This conclusion reflected the following rationale:

- The impossibility for the managers to transfer their shares to third parties until a specific holding period
- The connection between the share assignment and the work provided by the managers

Nonetheless, the Revenue Agency clarified that any income such as dividends and/or capital gains attributable to managers as a result of the ownership of the shares acquired through the non-proportional assignment maintains the character of "financial income" as "*the participation to the profits is not subject to the existence of the employment relationship, since the beneficiary could maintain the shares even if the work relationship is terminated*."

Consequently, the classification of the income received from the shareholding under

Article 44, para. 1, let. e of T.U.I.R. (*i.e.*, dividends from shareholding) does not depend on whether a work relationship exists between the recipient of the profits and the distributing company.

The fact that the characterization as "financial income" does not depend on the existence of an employment relationship raises the same questions regarding the loss of enhanced economic rights due to departure clauses.

## NEW RULES ON CARRIED INTEREST

Given the uncertainty of this situation and a desire to attract high-skilled individuals and capital to Italy, the Italian government introduced a new provision laying down the conditions under which carried interest is to be considered financial income and not employment income.

With Art. 60 of the Decree, the Italian government introduced new rules that address proceeds derived from direct or indirect participation in companies, entities, or collective investment undertakings that are represented by shares, quotas units, or other financial instruments granting enhanced economic rights ("eligible instruments").

Under the new regime, if certain conditions are met,

- income and gain derived from direct or indirect participations in companies, other entities, or collective investment undertakings ("C.I.U.'s") established in Italy, or in a jurisdiction allowing for adequate exchange of information with Italy (*i.e.*, "white list jurisdictions"),
- will be deemed to constitute investment income (generally taxed at 26%), rather than income from personal services (taxed at progressive rates up to 43% plus surcharges)
- when received by employees and directors ("Managers") of such companies, investment undertakings ("relevant funds or companies"), or other persons controlling or managing such companies (*e.g.*, employees and directors of the management company of an investment fund).

Those eligible for the incentive include managers and employees of advisory companies, investment companies, and target companies. In this regard, it should be noted that advisory companies are included within "eligible persons" since they have a key role in investment strategies, although they have no investment decision ability and therefore no direct responsibility. On the other hand, excluded persons consist of professionals such as lawyers acting as consultants.

The application of the special regime is subject to three conditions:

- *1% Investment Threshold.* The actual investment made by all managers requires an effective disbursement greater than or equal to 1% of the total investments of the relevant fund or company.
- *Repayment Subordination.* The proceeds from shares, quotas, or financial instruments are only payable once all the fund investors or company shareholders have received an amount equal to the invested capital plus a minimum yield (*viz.*, a hurdle rate) set out by the fund regulations or by law.

- *Holding Period.* The relevant shares, units, and financial instruments must be held for at least five years or, if earlier, until the date of a change of control of the relevant company or entity, or a change of the management company of the collective investment undertaking.

Before analyzing the above conditions, it should be highlighted that the new regime concerns only proceeds derived from the holding of financial instruments with special economic rights. It does not apply to income derived from the financial instrument assignment. Indeed, upon assignment (*i.e.*, subscription or acquisition) of any eligible instruments, the excess in value between the fair market value of shares, quotas, or financial instruments and the actual amount paid will be treated as a benefit in kind and taxed as employment income. Such income is taxed at progressive rates of up to 43% on taxable income exceeding €75,000.

***"The new regime applies to carried interests if all the other fund investors or shareholders other than the holders of the carry have received an amount equal to the invested capital hurdle."***

**1% Investment Threshold**

The Circular clarifies two points with regard to funds.

First, the Managers' 1% total investment is represented by the effective capital invested, which also takes into consideration financial instruments other than those with enhanced economic rights and securities (with or without enhanced economic rights) ascribed to Managers as fringe benefits and taxed in their hands as employment or self-employment income. Considering that the Decree makes reference to direct or indirect participations in eligible instruments, where financial instruments with special economic rights are held through a dedicated company or trust or subscribed by a management company in which the holders of the carry participate, the indirect participation will be counted for the purposes of the 1% threshold.

Second, the overall investment made by the relevant fund is determined with reference to the amounts the fund has effectively received from investors (*viz.*, drawdowns), including management fees, and net of any third-party debt. In other words, the carry holders' disbursement must be proportional to the capital actually invested by the other investors, rather than to the amounts employed to acquire the underlying investments, which usually include substantial financing.

The Circular also clarifies that the 1% threshold must be verified at the end of the subscription period. Once the 1% threshold is exceeded, further transfers of the same securities with special economic rights to a person other than an employee or director (*e.g.*, by means of succession) will not trigger any consequence for the remaining carry holders even if the overall interest falls below 1%. The same conclusion can be achieved in a case where the manager terminates his or her employment relationship. Clearly this is not effective where an abuse of law exists, such as would be the case where all steps are part of a prearranged plan.

The Circular also provides useful comments on the application of the Decree when the eligible instruments are issued by a company instead of a collective investment vehicle. With regard to companies, the minimum threshold requirement must be commensurate with the company's net equity, to be calculated at fair market value determined through a specific appraisal. Furthermore, to meet the 1% investment condition, the Managers' investment must be adjusted to account for any further investment in the company by other investors.

The Circular also specifies that the foregoing condition is not met if the financial instruments are acquired by the Mangers through loans granted by the employer or third parties under favorable conditions. Where that occurs, there is no alignment between the interests of the Managers and those of the investors. In contrast, the condition is met if the financial instruments are subscribed through loans granted at rates lower than market standards provided that the loan granted in connection to the employment relationship is treated as benefit in kind pursuant to Art. 51, para. 4 of T.U.I.R.

### Repayment Subordination

The Circular clarifies that the new regime applies to carried interests if all the other fund investors or shareholders other than the holders of the carry have received an amount equal to the invested capital hurdle.

If the repayment subordination condition is met, the new regime is applicable to both reimbursements and disposals of eligible instruments.

Only the carried interest must be subordinated in order to satisfy the regime.

### Holding Period

A minimum holding period of five years must be met, during which all financial instruments held by Managers comprising the 1% investment threshold must be held. Hence, the holding period requirement also applies to ordinary units or interests issued by C.I.U.'s, companies, and entities and held by all carry holders. If a securities disposal occurs before the five-year period ends, the regime will not apply.

The Circular clarifies that the five-year holding period will be determined starting from the end of the subscription period for C.I.U.'s or on the date of subscription of the capital injection for entities other than C.I.U.'s.

In the event of the death of the employees or administrators, the balance of the five-year holding period requirement must be met by the heirs. Moreover, in the case of a securities disposal that triggers a "change of control" during the five-year holding period, the carried interest regime continues to be applicable. However, in the case of a transfer of the units or interests within the five-year period, such as by a change in members of the management team, a new holding period begins from the date of the change of ownership.

The holding period condition does not mandate that the distribution of carried interest proceeds be deferred until the end of the holding period. Indeed, the carried interest can be effectively received by the Managers within the five-year holding period provided that the financial instruments are held for the minimum period required.

## OTHER CLARIFICATIONS

If all the foregoing requirements are met, the income received by the Managers is treated as financial income, irrespective of any connection to employment activity provided to the company, entity, or C.I.U. (or to related or controlled entities). On the other hand, if the conditions are not met, the carried interest is not automatically treated as employment income for tax purposes.

The Circular also provides important comments on the treatment of carried interest proceeds in the case any of the conditions are not met. In particular, it clarifies that

carried interest could continue to be treated as financial income provided that it is not actually used to remunerate an employment or self-employment activity carried out by the Manager and highlights facts to consider when classifying the carried interest as employment income or financial income. For such purposes, a carried interest may generally fall within the category of financial income if the following facts are present:

- Managers' interests are aligned with investors' interests
- Managers bear the actual risk of loss of the invested capital
- Managers and other investors hold the same financial instruments with special economic rights (*i.e.*, securities with special economic rights are not reserved to Managers)

In contrast, the carried interest may be classified as employment income where the following facts are present:

- Arrangements exist distinguishing between good departures, such as termination other than for cause, and bad departures, such termination for cause or early resignation, unless they are mitigated by other circumstances.
- Managers' investment risks are neutralized (*e.g.*, clauses that guarantee Managers total reimbursement of invested capital).
- Managers receive compensation below market standards.

The Circular clarifies that the possibility for the holders of the carry to retain ownership of the units or interests even after a departure may be considered sufficient proof of the financial character of the instrument, even if none of the conditions set by the Decree are met.

In any case, under such circumstances, the carry holders may submit a ruling request to the Italian Tax Authorities in order to confirm the tax treatment of their carried interest schemes.

The new provisions apply to income realized on or after April 24, 2017. Investment plans approved as of April 24, 2017, may be amended in order to benefit from the new rules.

# INDIVIDUAL, CORPORATE, AND TRUST NEWS FROM FRANCE

**Authors**
Alev Fanny Karaman
Nina Krauthamer

**Tags**
France
French Tax Bills
Trusts

As explained in the January 2017 edition of Insights, the end of the year in France is always marked by a fiscal legislative process to amend the current year's finance law and to draft the law for the upcoming year.[1]

The present article summarizes the main changes to the individual and corporate tax regimes under both the Amended Finance Law for 2017 and the 2018 Finance Law[2] – the first of French President Emmanuel Macron's five-year term – and recent case law relating to the treatment of trusts for French wealth tax purposes.

## INDIVIDUALS

### French Wealth Tax

The French wealth tax is currently applicable to the worldwide assets of French residents having a net worth in excess of €1.3 million and to certain French-situs assets belonging to nonresidents whose net worth is in excess of this threshold. As of January 1, 2018, the French wealth tax will only be applicable to real estate or certain real estate rights.

### Individual Income Tax Rates

Individual income tax rates have been adjusted for inflation by 1%. The new income tax brackets will be as follows:

| Income | Tax Rate |
|---|---|
| €0 – €9,807 | 0% |
| €9,807 – €27,086 | 14% |
| €27,086 – €72,617 | 30% |
| €72,617 – €153,783 | 41% |
| In excess of €153,783 | 45% |

1 See, in detail, "News on the French Front: Tax Law Changes for Corporations and Individuals," *Insights* 1 (2017).

2 Additional changes are contained in both bills but will not be discussed for purposes of this article.

## Withholding Tax and Flat Tax

The introduction of a withholding tax-based system – announced last year[3] – has been delayed by one year, and will now come into effect on January 1, 2019.

In addition, a flat tax of 30% will be applied as of January 1, 2018, on financial income (*i.e.*, dividends, interest, and capital gains realized on the disposition of assets generating such income). The components of the flat tax are broken down as follows:

- 12.8% of income tax
- 17.2% of social charges[4]

As a result, passive-type income that is subject to the flat tax is not taxed at graduate rates but at an overall 30% rate, no matter the tax bracket of the recipient. Taxpayers will be able to elect out of this regime and be subject to ordinary income tax rates as calculated under current law. This would enable them to take advantage of so-called abatements on dividends and share sales.

# CORPORATIONS

## Corporate Income Tax Rate

The current general French corporate income tax rate is 33$^1/_3$%. It will be gradually decreased as follows:

- In 2018, the first €500,000 of taxable income will be subject to a 28% rate, with the excess still taxed at the current 33$^1/_3$% rate.
- By 2019, the excess over €500,000 will be taxed at 31%.
- In 2020, all taxable income will be subject to a 28% rate. This will be further decreased to 26.5% in 2021 and to 25% in 2022.

The 15% tax rate applicable to small- and medium-sized entities will continue to be applicable.

## Additional 3% Tax

Under Francois Hollande's presidency, French tax law provided for a 3% tax on dividend distributions made by corporations subject to French corporate income tax.[5] The dividend amount subject to this tax included dividend distributions received from the distributing corporation's subsidiaries.

This provision was challenged several times both at the French Constitutional Court and the E.U. levels as being contrary to the French Constitution[6] and to the Europe-

---

3 See Withholding Tax as of 2018 with 2017 Tax-Free for Certain Types of Income in "News on the French Front."

4 The 17.2% rate results from the increase of the *Contribution Sociale Generalisee* ("C.S.G.") from 15.5% to 17.2%.

5 Former first paragraph of Article 235 *ter* ZCA of the French Tax Code.

6 Case No. 2016-571 QPC, September 30, 2016; Case No. 2017-660 QPC,

an Parent-Subsidiary Directive,[7] respectively.

As a result of the above decisions, the additional 3% tax has been repealed and French taxpayers are entitled to a reimbursement for amounts paid.

In order to counter the resulting tax loss, the Amended Tax Law for 2017 provides for a one-time additional corporate income tax on corporations with tax years ending between December 31, 2017, and December 30, 2018. The tax is computed as follows:

| Turnover/Gross Receipts | Additional Tax Applied to Corporate Income Tax Liability | | Total Additional Tax | Total Effective Corporate Income Tax Rate (2017) |
|---|---|---|---|---|
| **> €1 Billion** | 15% | – | 15% | 39.4%<br>($33^1/_3\%$ + $33^1/_3\%$ x 3.3% +<br>$33^1/_3\%$ x 15%) |
| **> €3 Billion** | 15% | 15% | 30% | 44.4%<br>($33^1/_3\%$ + $33^1/_3\%$ x 3.3% +<br>$33^1/_3\%$ x 15% +<br>$33^1/_3\%$ x 15%) |

## TRUSTS[8]

Article 885 G *ter* of the French Tax Code provides that, for purposes of the French wealth tax, trust assets and capitalized trust income must generally be included in the grantor's wealth tax basis. As a result, no distinction is made between various types of trust; the grantor is subject to wealth tax on the trust assets and capitalized income, even in the case of a discretionary and irrevocable trust.

The French Constitutional Court, in a decision dated December 15, 2017, confirmed that Article 885 G *ter* is valid and does not violate the French Constitution.[9] However, it provided an important caveat: Article 885 G *ter* only sets a simple presumption that the trust assets and capitalized income are includable in the settlor's wealth tax basis. The burden is thus on settlors to prove that they are not the owners of the assets or the capitalized income and that they cannot benefit from such assets or income.

October 6, 2017.

7 CJEU, AFEP and others, Case C-365/16, May 17, 2017.

8 French corporations are also subject to a 3.3% social contribution on corporate income tax liabilities.

9 Decision No. 2017-679 QPC, December 15, 2017.

# INCOME SHIFTING: COMMON OWNERSHIP OR CONTROL UNDER CODE §482 IN AN INBOUND TRANSACTION

**Author**
Stanley C. Ruchelman

**Tags**
Code §482
Control
I.P.U.
LB&I
Transfer Pricing

## INTRODUCTION

The Large Business and International Division of the I.R.S. ("LB&I") periodically develops international practice units ("I.P.U.'s") that serve as training material for international examiners. I.P.U.'s provide explanations of general tax concepts and information about a specific type of transaction. Because I.P.U.'s are not official pronouncements of law, they cannot be used, cited, or relied upon as authority. Nonetheless, they explain the general approach that will be followed by an LB&I examiner and are helpful when preparing for an I.R.S. examination of a multinational group.

In November 2017, the I.R.S. issued an I.P.U. entitled "Common Ownership or Control Under IRC 482 – Inbound." It serves as a primer for determining whether sufficient control exists between two parties to bring the arm's length transfer pricing rules of Code §482 into play.

On the same date, the I.R.S. issued a sister I.P.U. for outbound transactions, "Common Ownership or Control Under IRC 482 – Outbound." It is based on the same set of principles and is virtually identical to concepts of control for inbound transactions.

This article explains how the I.R.S. looks at the issue of control. How is it defined? In what fact patterns does it exist? In approaching these issues, this article focuses on the context of a non-U.S.-based group with operations in the U.S.

## CONTEXT

The I.P.U. begins with the acknowledgement that a foreign-based group operating in the U.S. generally do so through a U.S. subsidiary. If the group sources its product outside the U.S. for sale in the U.S., the U.S. subsidiary generally is charged with the task of establishing a marketing plan and implementing that plan through a U.S. sales network.

The I.P.U. identifies the following types of transactions that often exist between the U.S. subsidiary and its parent or affiliates based abroad:

- Loans
- Leases
- Sales
- Licenses
- Services

In comparison to business transactions entered into by unrelated parties, where each party is acting solely to increase its own economic goals, the I.P.U. expresses the view that related parties may take steps to price transactions based on other factors. Where that occurs, a U.S. taxpayer may underreport its U.S. taxable income and Federal income taxes.

To prevent tax slippage arising from related-party transactions, Code §482 authorizes the I.R.S. to conduct an examination and to reallocate income among related parties when necessary to reflect arm's length pricing. The purpose of Code §482 is to ensure that taxpayers clearly reflect income from "controlled transactions" and to prevent U.S. taxpayers from avoiding taxation by artificially shifting income.

However, the I.P.U. acknowledges that the mere fact that two parties are related does not create any presumption that intercompany pricing is other than arm's length.

A transaction is a controlled transaction if it occurs between two or more organizations, trades, or businesses that are either owned or controlled by the same interests. A controlled group of taxpayers is a group of taxpayers that are owned or controlled directly or indirectly by the same interests.[1] Therefore, a controlled transaction is any transaction or transfer between two or more members of the same group of controlled taxpayers.

In contrast, an uncontrolled transaction is any transaction between two or more taxpayers that are not members of the same controlled group.[2]

Thus, the term "controlled" in the Treasury Regulations is a shorthand that generally refers to the concepts of both common ownership and common control, except where it is necessary to distinguish between those concepts.

The term "controlled" is defined as any kind of control (i) whether direct or indirect, (ii) whether or not legally enforceable, (iii) however exercisable or exercised, and (iv) including arrangements by which two parties act in concert or with a common goal or purpose.[3] It is the reality of control that is the decisive factor and not its form or the mode through which control is exercised. Control is presumed to exist if income or deductions have been arbitrarily shifted between related parties.

Common ownership or control is determined at the time the parties agree to perform a transaction, even if the parties perform the transaction later.

## CONTROL THROUGH DIRECT OWNERSHIP

The first step is to determine whether the "ownership" test is satisfied. The position of the I.R.S. is that common ownership exists if there is a greater than 50% ownership by the same related-party interests.

Ownership can be direct or indirect. Direct ownership occurs when one party directly owns stock or another ownership interest in its name. This is illustrated in the following diagram:

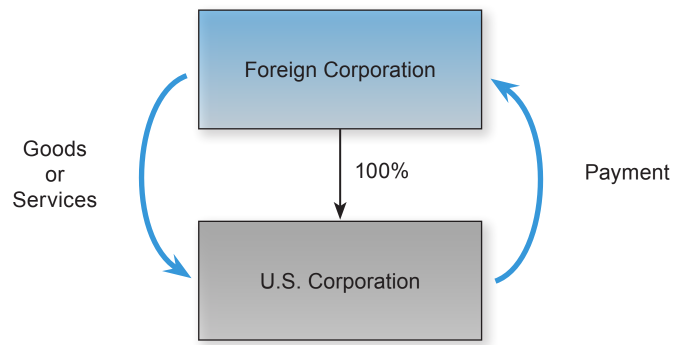
---

[1] Treas. Reg. 1.482-1(i)(6).

[2] Treas. Reg. 1.482-1(i)(8).

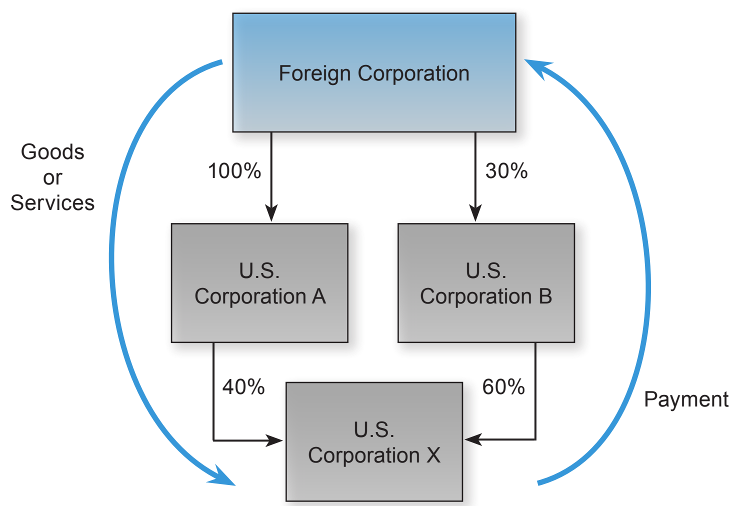
[3] Treas. Reg. 1.482-1(i)(4)

### Direct Ownership




Indirect ownership occurs when one party owns the stock or other ownership interest of another party indirectly through ownership of one or more other, intervening parties. This is illustrated in the following diagram.

### Indirect Ownership




In the diagram, Foreign Corporation owns 100% of the stock of U.S. Corporation A and 35% of the stock of U.S. Corporation B. U.S. Corporation A owns 40% of the stock of U.S. Corporation X, and U.S. Corporation B owns 60% of the stock of U.S. Corporation X. Therefore, Foreign Corporation indirectly owns 61% of the stock of U.S. Corporation X. The facts and circumstances would need further development to determine if common control exists.

If, in the above diagram, U.S. Corporation B were to have only two shareholders, *viz.*, Foreign Corporation and an unrelated U.S. Corporation C (not shown in diagram), Foreign Corporation may not be able to exert actual control over pricing even though it directly owns 40% and indirectly owns another 21% of U.S. Corporation X. On the other hand, if unrelated U.S. Corporation C also purchases goods or services from U.S. Corporation X, both Foreign Corporation and U.S. Corporation C could be acting in concert to keep prices for purchased goods or services below an arm's length amount. In such case control would exist and the prices charged by U.S. Corporation X to Foreign Corporation and U.S. Corporation C may not be at arm's length.

The I.P.U. addresses a case in which the facts were almost identical to those in the diagram. In *W.L. Gore v. Commr.*,[4] the U.S. taxpayer entered into a 50/50 joint venture with a Japanese corporation in which it held a 30% ownership interest. The U.S. taxpayer granted to the joint venture the exclusive license to use certain technology in Japan on a royalty-free basis. The joint venture's rights to license the technology acquired from the petitioner were severely circumscribed. The agreement also provided that, in case either the taxpayer or the joint venture were to improve the technology or develop new technology, each would promptly disclose such technology and grant a royalty-free license to the other. A similar license arrangement existed between the Japanese corporation and the joint venture.

***"Common ownership or control is determined at the time the parties agree to perform a transaction."***

The I.R.S. contended that the joint venture and the U.S. taxpayer were under common control. In part, the I.R.S. argued that the U.S. taxpayer not only owned a direct 50% interest in the joint venture but also an indirect 15% interest through the Japanese corporation. The joint venture agreement provided for royalty-free cross licenses. It also alleged managerial control existed in the U.S. corporation and that the two parties to the joint venture were acting in concert.

The taxpayer filed a motion for summary judgment, in part because it did not directly own sufficient shares in the joint venture to control its activities. The motion was denied. The court accepted several arguments raised by the I.R.S. in support of its position that summary judgment was not appropriate in the circumstances. One of those arguments was the existence of a 15% indirect interest in the joint venture through the taxpayer's ownership of a 30% interest in its joint venture partner. The court stated that the 30% ownership of the joint venture partner can "properly be considered even if the usual standards for attribution of ownership, such as those found in section 318, are not met." Whether that 30% ownership provided the U.S. taxpayer with control was a matter of fact that would have to be determined at trial.

The I.P.U. views indirect control through an unrelated party as an important factor, stating:

> While W.L. Gore could be viewed as a case that the Tax Court decided based on common ownership (*i.e.*, taxpayer's 65% overall ownership interest in JV), the Tax Court also addressed common control factors such as managerial control in reaching its decision. Thus, the Tax Court in W.L. Gore addressed both common ownership and control for purposes of IRC 482.

## COMMON CONTROL

In a situation where Code §482 can apply only if there is common control (due to the absence of common ownership by a majority of the same interests), common control might result in any number of ways depending on the facts of the case.

### Voting Control

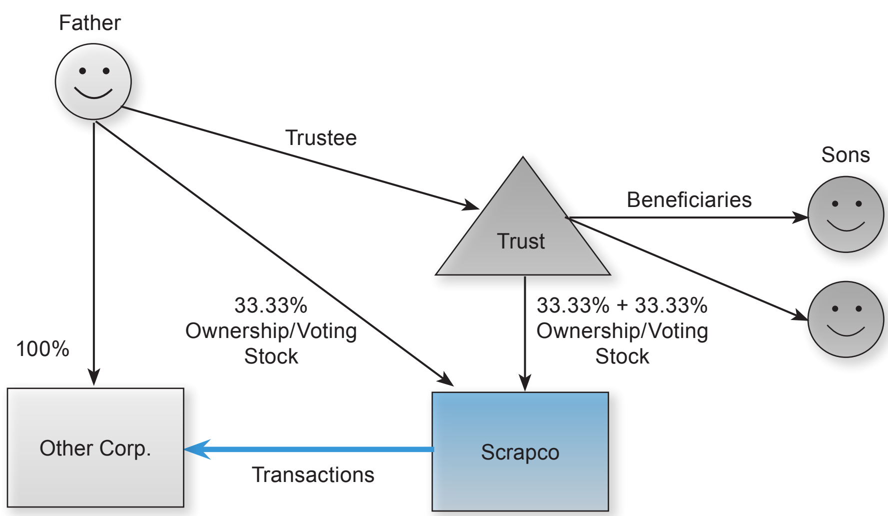
Where a taxpayer has legal voting control over another entity, the I.P.U. states that the control element will usually be met for purposes of Code §482. This is true even when a taxpayer owns less than 50% of the value of the stock, yet holds a majority of the voting stock, of a corporation.

---

[4] T.C. Memo 1995-96.

This fact pattern is illustrated in *Diefenthal v. U.S.*,[5] where one third of the stock in a corporation called Scrapco was owned by a father and the other two thirds were split between two sons. The stock of the two sons was held in trust and the father was named as the trustee. Acting as trustee, the father had the power to vote two thirds of the shares, and acting as shareholder, the father voted the balance of the outstanding shares. The Code §482 issue was whether Scrapco engaged in arm's length transactions with a corporation owned wholly by the father.

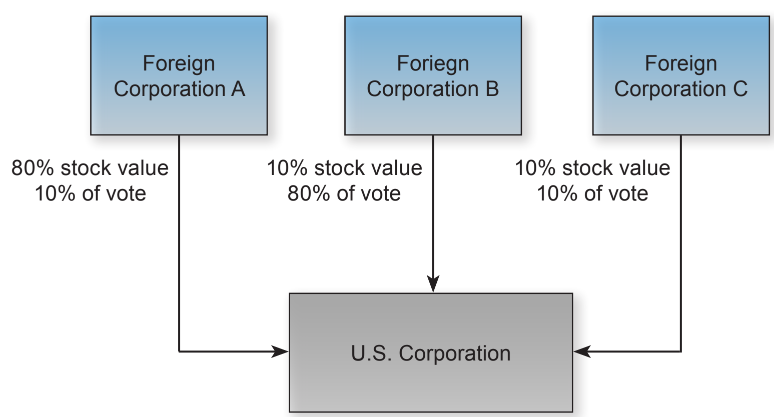
**Voting Control**




The district court held that common control was present for Code §482 purposes because the father had power to vote 100% of Scrapco's stock and also owned 100% of the other corporation that participated in a transaction with Scrapco. The court reasoned that, on the basis of voting control, Code §482 was applicable.

The I.P.U. then proceeds to posit the following fact pattern as an illustration of control without ownership of more than 50% of the shares. Unrelated entities Foreign Corporation A, Foreign Corporation B, and Foreign Corporation C all have ownership interests in U.S. Corporation as illustrated in the following diagram:

**Voting Control**




[5] 367 F. Supp. 506, 511 (E.D. La. 1973).

U.S. Corporation's governing documents state that all material company decisions will be made by a majority vote of the shareholders. Because voting power is typically controlled by ownership of voting shares, Foreign Corporation B clearly has common control of U.S. Corporation. The I.P.U. then asks whether U.S. Corporation is also controlled by Foreign Corporation A because of its ownership of 80% of the stock. While the I.P.U. does not provide an answer, it would appear that voting control trumps majority ownership, in the absence of other arrangements.

## Practical Control

Even if a taxpayer does not have absolute voting control, there are scenarios where the taxpayer, on a practical level, has sufficient control so that common control is met.

One example involves a fact pattern in which 49% of a corporation's stock is owned by a single entity and the other 51% is widely dispersed among many other shareholders, none of which owns more than 1%. Clearly, the owner of the 49% interest controls the corporation.

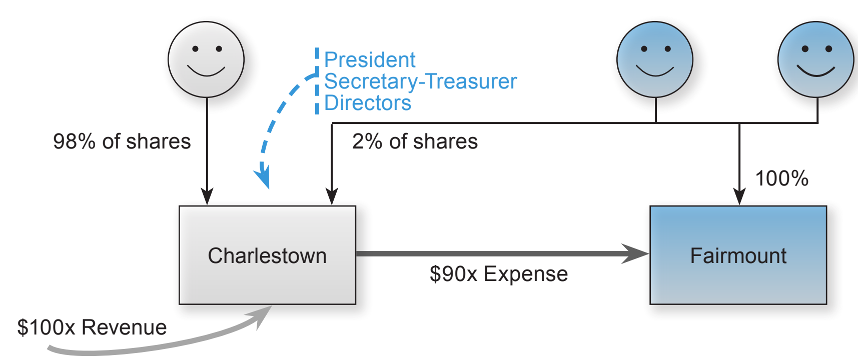
A second example involves a non-majority owner of a joint venture entity that provides all the debt financing to the joint venture or supplies the joint venture with essential components under an exclusive supply agreement. The presence or absence of control would depend upon the degree of ownership and the significance and size of the particular transaction relative to the joint venture business.

## Management Control

Common control for purposes of Code §482 may be established based on one party's management control of another entity. Thus, for example, in *Charles Town, Inc. v. Commr.*,[6] the court held that common control existed where there was only 2% common ownership.

In the facts of the case, two brothers owned all of the stock of Fairmount. The brothers formed a new corporation ("Charles Town"), which acquired a race track. The brothers owned only 2% of the outstanding stock in Charles Town. A cousin owned the other 98%. However, the brothers served as president, secretary-treasurer, and directors of Charles Town. Fairmount advanced funds to Charles Town for operations at the race track. Charles Town operated the track and retained 10% of the net profits, while paying the remaining profits to Fairmount. The facts are illustrated in the following diagram:

**Management Control**




[6] 372 F.2d 415 (4th Cir. 1967), affg. T.C. Memo 1966-15.

The I.R.S. allocated all income received by Fairmount to Charles Town. Charles Town contended that insufficient control existed between Charles Town and Fairmount. However, the court held that of both Charles Town and Fairmount were controlled by the two brothers. While they owned only 2% of Charles Town shares, the court found that the brothers controlled Charles Town because they caused the corporation to be formed, constituted the majority of the board of directors, were principal officers of the corporation active in its management, and made all major decisions with respect to the allocation of income and expenses.

## CONTROL IN CONCERT WITH AN UNCONTROLLED PARTY

Another indicator of common control occurs when two or more entities "act in concert." The I.P.U. acknowledges that non-majority shareholders and owners can have control over another entity if they act in concert as a majority with a common goal to shift income or expenses to or from the entity.

***"Non-majority shareholders and owners can have control over another entity if they act in concert as a majority."***

The paradigm case is *B. Forman Co. v. Commr.*,[7] where the Second Circuit Court of Appeals reversed the Tax Court and concluded that common control exists where two unrelated corporations are equal owners in a third corporation and act in concert to direct the actions of the third corporation. In the case, two unrelated corporations made equal interest-free loans to a third corporation "all of whose stock they owned and all of whose directors and officers were their alter egos." Using a "realistic analysis," the court found that the two unrelated corporations exerted control even though they had no common shareholders, directors, or officers. The court found that the two unrelated corporations acted with a common goal to shift income. Thus, the court upheld I.R.S. reallocations between the controlled corporation and its two corporate owners.

The I.P.U. points to the importance of the fact that the shareholders' economic and tax interests were lined up in parallel with each other. This made the income shifting determination more obvious. However, if two taxpayer/owners have clearly adverse interests, a common goal may be absent, which could prevent the application of Code §482.

Another consideration in finding that unrelated taxpayers are acting in concert is the dependence of each company on the other. An example is *South Texas Rice Warehouse Co. v Commr.*[8] The taxpayer owned a rice-drying warehouse, while a related business leased the warehouse from the taxpayer and operated the warehouse. Four families each owned 25% of both entities, although the family members were not always the same.

The I.R.S. proposed an adjustment in the income of the two businesses in order to properly reflect income among controlled parties. The adjustment was contested in the Tax Court on the grounds that the same interests did not control the two businesses within the meaning of Code §482. Acknowledging that the two businesses were controlled by different members of the same two families, the taxpayer argued

---

7 453 F.2d 1144, 1155 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972).

8 43 T.C. 540 (1965) affd., 366 F.2d 890 (5th Cir. 1966), cert. denied, 386 U.S. 1016 (1967).

that Code §482 contains no provision for the imputation of ownership or control because of ownership by related parties.

The court disagreed with the taxpayer, stating that the requisite control may exist even though it is not legally enforceable. It is the reality of the control which is decisive, not its form or the mode of its exercise. Under the facts of the case, common control existed between the two businesses in part because the two business were owned only by members of two families and in part by the interdependence of one business on the other. One owned the facility, the other leased the facility. One leased land and water to rice farmers and the other operated a rice drying and warehousing business. For the business of drying and storing rice, not only was a facility required but also rice throughput for drying. When looked at as a whole, the lands that were leased, the facilities that were operated, and the rice that was grown were parts of an integrated business in which the owners were members of the same two families, who had common interests and always acted in concert.

The I.P.U. goes on to caution that the mere existence of a family unit owning two businesses that conduct business with each other is not always sufficient to justify a conclusion that the companies are under common control. An example is *Brittingham v. Commr.*[9]

The case involved two brothers and their immediate families. Each brother owned, directly and through his immediate family, 37% of a U.S. corporation and participated on the board of directors of that corporation. However, only one brother served as an operating officer of that corporation. The U.S. corporation purchased inventory from a Mexican corporation that was wholly owned by the other brother, his mother, and his wife.

The I.R.S. adjusted the intercompany purchase price paid by the U.S. corporation, asserting the price was artificially high in order to shift profits. Code §482 applied in the view of the I.R.S. because the brothers and their families collectively owned or controlled both corporations so that the same interest controlled both corporations.

The Tax Court rejected the I.R.S. position, because no evidence existed that the corporations were operated in concert or that profits were artificially shifted to the Mexican corporation. Only one brother, along with his wife and mother, owned the Mexican corporation. He was not active in operating management of the U.S. corporation, and it was not credible the brother who operated the U.S. corporation would shift profits to a company he did not own. The I.P.U. agreed with the court in concluding that in light of the facts in the case, neither the common ownership test nor the common control test was satisfied and Code §482 was inapplicable.

## TIMING OF CONTROL

In many cases, the timing of common ownership or control is not an issue because the relevant events all occurred at a single point in time. But in some cases, where relevant events occur over a period of time, the timing of common ownership or control can be an issue. In these circumstances, it is necessary to determine the appropriate point in time when the parties were commonly owned or controlled and took steps to enter a transaction under a specific pricing arrangement.

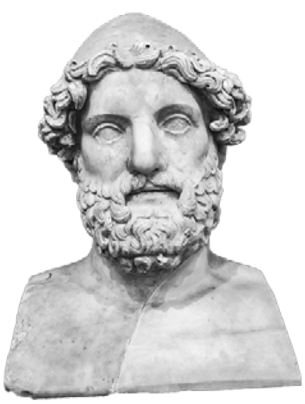
---

[9] 66 T.C. 373 (1976), affd., 598 F.2d 1375 (5th Cir. 1979).

*DHL Corp. & Subsidiaries v. Commr.*[10] involved the global package delivery company DHL, a U.S. corporation. It was part of a global network in which DHL handled U.S. operations exclusively. DHLI held international rights to use the DHL trademark and was based in Hong Kong. Independent local agents conducted DHL's international operations and paid a network fee to DHLI.

In 1989, two foreign corporations entered into a memorandum of understanding with DHL to purchase (i) a 60% ownership stake in DHLI for $450 million and (ii) the DHL trademark for $50 million, subject to confirmation of the tax effect for the trademark transaction. Subsequently, but before the acquisition was concluded in 1990, DHL and DHLI executed an agreement granting DHLI an option to purchase the DHL trademark for $20 million. Shortly thereafter, a final agreement was reached with the foreign corporations under which the purchasers acquired: (i) a 12.5% stock interest in DHLI, with an option to purchase an additional 45% interest; (ii) a 2.5% interest in DHL; and (3) an option to purchase the DHL trademark for $20 million. On June 7, 1992, the two foreign corporations exercised their stock option, purchasing a majority stake in DHLI. In autumn 1992, the foreign corporations, as majority owners of DHLI, caused DHLI to exercise its option to purchase the DHL trademark rights for $20 million.

Clearly, DHLI's option to acquire the DHL trademark was negotiated when DHL and DHLI were related parties. Clearly, too, DHLI was not related to DHL at the time the option was exercised. This presented the court with the following question: At the time the purchase of the trademark was completed and DHLI and DHL were not under common control, was Code §482 applicable? The Tax Court answered in the affirmative, and that conclusion was confirmed on appeal.



Code §482 was applicable because DHL and DHLI were commonly controlled entities as of time of their negotiations and the date on which terms were set. The fact that an uncontrolled party was also involved did not remove the terms of the transaction from the ambit of Code §482 because the uncontrolled party was either indifferent to the price or possibly advantaged by the price. The price was determined by a taxpayer intent on shifting income and in position to effect an income shift. Of note was the fact that the net value of the entire transaction was not affected by the reduction in the price of the trademark as other revisions offset that decrease in price.

A similar result was reached in *GAC Produce Co. v. Commr.*,[11] a case in which a U.S. marketing company agreed to help market fresh produce grown and distributed by a group of companies based in Mexico. The agreement with the U.S. marketing company purported to allocate the prices among the U.S. and Mexican members of the Mexican group. When the U.S. member of the Mexican group was examined by the I.R.S., a transfer pricing adjustment was proposed between the U.S. group member and related suppliers in Mexico. The U.S. member argued that Code §482 was not applicable because the internal pricing was controlled by the agreement with the U.S. marketing company. The Tax Court agreed with the I.R.S. The U.S. marketing company was indifferent to the method by which the Mexican based group internally allocated income.

However, the I.P.U. cautions that the result in GAC Produce could be different in

---

10 T.C. Memo 1998-461, affd. in part and revd. in part, 285 F.3d 1210, 1217 (9th Cir. 2002).

11 77 T.C. Memo 1999-134.

other facts. Control would not exist where the unrelated party is not indifferent to the shift of profits – meaning that bears an economic loss from each dollar shifted – and, for that reason, the unrelated party keeps the controlled parties from shifting income.

## CONCLUSION

*"For transfer pricing purposes, 'control' is given a broader meaning that looks not only to ownership but to control of any kind."*

Arm's length transfer pricing rules are designed to prevent controlled parties from manipulating transaction values in order to reduce taxes inappropriately. Operating management often believe that control is determined based solely on the existence of common ownership at the time of a transaction. As demonstrated in the I.P.U., this approach to equating control solely with ownership is flawed. For transfer pricing purposes, "control" is given a broader meaning that looks not only to ownership but to control of any kind (i) whether direct or indirect, (ii) whether or not legally enforceable, (iii) however exercisable or exercised, and (iv) including arrangements by which two parties act in concert or with a common goal or purpose.

# UPDATES & OTHER TIDBITS

**Authors**
Neha Rastogi
Nina Krauthamer

**Tags**
Blacklist
Brexit
H.M.R.C.
Inheritance Tax
I.T.I.N.
Tax Haven

## EXPIRED INDIVIDUAL TAX IDENTIFICATION NUMBERS

Individual Tax Identification Numbers ("I.T.I.N.'s") that have not been used on a Federal tax return at least once in the last three consecutive years (*i.e.*, 2014, 2015, and 2016) and I.T.I.N.'s with middle digits 70, 71, 72, or 80 expired December 31, 2017. Affected taxpayers who expect to file a tax return in 2018 (*e.g.*, a Form 1040 for tax year 2017) must submit a renewal application as soon as possible to avoid refund and processing delays in 2018.

Taxpayers whose I.T.I.N.'s have middle digits of 70, 71, 72, or 80 have the option to renew I.T.I.N.'s for their entire family at the same time. Those who have received a renewal letter from the I.R.S. can renew the entire family's I.T.I.N.'s, even if some family members have I.T.I.N.'s with other middle digits. Family members include the tax filer, their spouse, and any dependents claimed on the tax return.

Federal returns that are submitted in 2018 with an expired I.T.I.N. will be processed. However, exemptions and/or certain tax credits will be disallowed. Taxpayers will receive a notice in the mail advising them of the change to their tax returns and the need to renew I.T.I.N.'s. Once an I.T.I.N. is renewed, any applicable exemptions and credits will be restored and refunds will be issued.

## E.U. NAMES U.S. POSSESSIONS AS NON-COOPERATIVE JURISDICTIONS FOR TAX PURPOSES

The U.S. possessions Guam and American Samoa are among the 17 tax havens blacklisted by the E.U. for failure to meet international standards for tax transparency, fair taxation, and mechanisms against base erosion and profit shifting.

The censure is attributed to several facts. Guam and America Samoa do not apply any automatic exchange of financial information and have not signed and ratified – including through their governing jurisdiction – the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance. They do not apply the B.E.P.S. minimum standards, nor have they committed to address these issues by the E.U. deadline, December 31, 2018.

The screening process for certain Caribbean jurisdictions, including the U.S. Virgin Islands, is on hold in light of the devastating storms that struck the region in September 2017, causing casualties and major damage to key infrastructure. However, these jurisdictions will be contacted by February 2018 to ensure that the matter can be resolved by the end of 2018.

Other countries on the E.U. blacklist include Bahrain, Barbados, Grenada, Korea, Macao SAR, Marshall Islands, Mongolia, Namibia, Palau, Panama, Saint Lucia, Samos, Trinidad and Tobago, Tunisia, and the United Arab Emirates.

## H.M.R.C. ISSUES GIFT TAX DEMANDS TO CONTRIBUTORS TO BREXIT REFERENDUM

The Brexit saga has seen yet another interesting twist. H.M.R.C. (the U.K. taxing authority) has issued sizable tax demands under the U.K.'s inheritance tax laws to several key Brexit figures including Peter Cruddas and Robert Edmiston, who donated large sums to Vote Leave for conducting Brexit campaigns in 2016.

Donations to political parties are usually tax exempt in the U.K.[1] However H.M.R.C. is of the view that the exemption is not available to donations made by individuals for a referendum campaign. A member of the Conservative Party reacted to the demand by stating that the government is penalizing people who had the audacity to challenge it. Another M.P. said that taxes must be paid if rightfully owed. Reportedly, at least one Remain supporter has received a demand as well.

Companies and financial institutions are not liable for inheritance tax and therefore do not face additional tax.

[1] Section 24 of Inheritance Tax Act, 1984.

## About Us

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

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

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

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

## Disclaimer



## Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.


### NEW YORK

150 EAST 58TH STREET, 22ND FLOOR, NEW YORK, NY 10155

| | | |
|---|---|---|
| Galia Antebi | antebi@ruchelaw.com | +1 212.755.3333 x 113 |
| Beate Erwin | erwin@ruchelaw.com | +1 212.755.3333 x 116 |
| Fanny Karaman | karaman@ruchelaw.com | +1 212.755.3333 x 127 |
| Nina Krauthamer | krauthamer@ruchelaw.com | +1 212.755.3333 x 118 |
| Jennifer Lapper | lapper@ruchelaw.com | +1 212.755.3333 x 124 |
| Andrew P. Mitchel | mitchel@ruchelaw.com | +1 212.755.3333 x 122 |
| Simon H. Prisk | prisk@ruchelaw.com | +1 212.755.3333 x 114 |
| Neha Rastogi | rastogi@ruchelaw.com | +1 212.755.3333 x 131 |
| Stanley C. Ruchelman | ruchelman@ruchelaw.com | +1 212.755.3333 x 111 |
| Sheryl Shah | shah@ruchelaw.com | +1 212.755.3333 x 112 |
| Rusudan Shervashidze | shervashidze@ruchelaw.com | +1 212.755.3333 x 117 |
| Francesca York | york@ruchelaw.com | +1 212.755.3333 x 125 |
| Elizabeth V. Zanet | zanet@ruchelaw.com | +1 212.755.3333 x 123 |

### TORONTO

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

| | | |
|---|---|---|
| Michael Peggs | peggs@ruchelaw.com | +1 212.755.3333 x 232 |


## Editorial Staff


Jennifer Lapper ............................... Managing Editor, Art Director

Francesca York ............................... Graphics Editor, Copyeditor

PHOTOS IN THIS ISSUE WERE TAKEN BY:

*Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.*