



INSIGHTS

**DOING BUSINESS POST-BREXIT:
WHAT TO EXPECT IN THE UNITED KINGDOM**

**QUALIFIED BUSINESS INCOME – ARE YOU
ELIGIBLE FOR A 20% DEDUCTION?**

**B.E.A.T.-ING BASE EROSION:
U.S. SUBJECTS LARGE CORPORATIONS TO
ANTI-ABUSE TAX**

AND MORE

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EDITORS' NOTE

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

- **Doing Business Post-Brexit: What to Expect in the United Kingdom.** The U.K. is firmly on course to leave the E.U., with a target date of March 29, 2019. After a difficult period of 18 months, agreements to address two important “divorce” issues – the exit payment and the status of Brits in the E.U. and Europeans in the U.K. on Brexit Day – have been reached, while a decision has been made to defer discussions regarding the border with Northern Ireland. Graham Busch of Gerald Edelman, Chartered Accountants, London, addresses these and other settled issues as well as those for which a decision has been kicked down the road.
- **Qualified Business Income – Are You Eligible for a 20% Deduction?** Have you ever been asked to define the undefinable? At first glance, the new 20% Q.B.I. deduction – a reduced tax rate for the self-employed and partnerships introduced by the Tax Cuts and Jobs Act (“T.C.J.A.”) – seems to be just that: a maze in which the general rule is modified in hidden ways through subdivisions of subsections and in definitions that have substantive effect. In their article, Stanley C. Ruchelman and Fanny Karaman logically guide the reader through detailed discussion supported by illustrations.
- **B.E.A.T.-ing Base Erosion: U.S. Subjects Large Corporations to Anti-Abuse Tax.** Cross-border payments to related parties have been an arrow in the quiver of cross-border tax planners since the time that income tax and global trade first intersected. The new Code §59A introduces the Base Erosion and Anti-Abuse Tax (“B.E.A.T.”) on large corporations that significantly reduce their U.S. tax liability through the use of cross-border payments to related persons. It is structured as another form of the now-repealed corporate Alternative Minimum Tax rather than a disallowance of a deduction in computing regular taxable income. Banks that have significant interest payments and U.S. companies that pay significant royalties for trademarks, copyrights, and know-how are the targets of the tax, provided that the 30% withholding tax is not imposed. Galia Antebi and Sheryl Shah explain how the tax is computed. Is this another step towards a global trade war?
- **Non-Corporate Taxation: Individuals & Partnerships Face Highs & Lows Under the T.C.J.A.** Most cross-border tax advisers with clients that are impacted by the T.C.J.A. focus on the principal items, such as B.E.A.T., G.I.L.T.I., and the like. However, the act contains many additional provisions that can affect the non-corporate cross-border investor. Taxes have been reduced, a holding period for capital gains treatment now applies to carried interests, the scope of like-kind exchanges has been limited, and the tax treatment of alimony payments has been changed. These are just a few of the items addressed by Sheryl Shah.
- **A New Opportunity for Nonresident Aliens – Ownership in an S-Corp.** U.S. tax law allows a domestic corporation to elect pass-thru tax treatment of income by making an S-corporation election. Several conditions must be satisfied before the election can be made, including a prohibition of any foreign

ownership. In an almost invisible provision of the T.C.J.A., U.S. tax law has been revised to allow an individual who is neither a citizen nor a U.S. resident to hold an indirect current interest in an S-corporation without causing an automatic termination of pass-thru treatment for the corporation. The key is for the current interest to be held through an Electing Small Business Trust that qualifies as a domestic trust for U.S. tax purposes. This may be a boon for Canadian-resident individuals who face mind and management issues when a U.S. L.L.C. is established to invest in a U.S. opportunity. Rusudan Shervashidze and Stanley C. Ruchelman explain all.

- **Partner Representatives and the New Partnership Audit Regime.** Commencing in January 2018, the I.R.S. began a new centralized audit regime with respect to partnerships. It replaces the concept of a “Tax Matters Partner” with a “Partnership Representative.” This is more than a change in name. Unless the partnership is able to elect out of the new rules and actually does so, the I.R.S. will only deal with the Partnership Representative, and the individual partners have no right to separately appeal any tax assessment. Additionally, the I.R.S. may now collect tax at the partnership level as a result of a tax audit. Simon Prisk examines these and other changes – including the opt-out provisions – that will affect partnerships, partners in the current taxable year, and partners at the time that year is examined by the I.R.S.
- **Updates & Other Tidbits.** This month, Tomi Oguntunde, Sheryl Shah, and Nina Krauthamer look briefly at four recent developments in international tax: (i) an I.R.S. directive temporarily halting new examinations involving cost sharing agreements that do not include stock-based compensation costs, (ii) an I.R.S. appeal of a Texas District Court case in which certain anti-inversion rules were invalidated for nonconformance with the Administrative Procedures Act, (iii) Dutch measures to eliminate intragroup dividend withholding tax and address abusive tax planning channeled through the Netherlands, and (iv) a revised timeline for implementation of withholding tax on certain transfers interests in publicly traded partnerships that own assets having involving effectively connected gain, which results in withholding tax under Code §1446(f).

We hope you enjoy this issue.

- The Editors

DOING BUSINESS POST-BREXIT: WHAT TO EXPECT IN THE UNITED KINGDOM

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Brexit
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BREXIT – A BRIEF REVISIT

The U.K. is firmly on course to leave the E.U., with a target date of March 29, 2019. Several U.K. and E.U. figures are backing the idea of a “transition” period, of around two years thereafter, to facilitate smooth implementation of the final Brexit deal and minimize disruption to businesses, tourists, and the like.

The terms “soft” and “hard” Brexit are often used in the debate over the terms of the departure from the E.U. While there is no strict definition of either, they refer to the closeness of the U.K.’s relationship with the E.U. post-Brexit. At one extreme, “hard” Brexit could involve the U.K. refusing to compromise on issues like the free movement of people, even if it meant leaving the single market. At the other end of the scale, a “soft” Brexit might follow a path similar to that of Norway, which is a member of the single market and must accept the free movement of people.

Politics aside, E.U. and U.K. negotiators have taken steps in recent months toward reaching agreements in principal regarding several contentious issues.

WHERE IS THE PROCESS TODAY?

After a difficult first 18 months since the U.K.’s decision to leave, three important “divorce” issues have been settled or addressed in a deal signed in December 2017.

- How much the U.K. owes the E.U. (the “Exit Payment”)?
- What happens to the Northern Ireland border?
- What happens to U.K. citizens living elsewhere in the E.U. and E.U. citizens living in the U.K.?

The Exit Payment

In a joint agreement between the U.K. Treasury and the E.U.’s chief Brexit negotiator Michel Barnier that was reached in December 2017, the U.K. government confirmed that it is committed to paying a “divorce bill” totaling between £35 billion and £39 billion (approximately \$47 billion to \$53 billion). This will cover Britain’s obligations to the E.U. “outstanding at December 31, 2020.”

The final amount is unlikely to be known for many years, as it depends on items such as future pensions and development projects. Government backbenchers have sought assurances that the payment will be contingent upon the agreement of a suitable outcome on future trade negotiations. However, Chancellor of the Exchequer Phillip Hammond has intimated that Britain will honor its commitment irrespective of any trade deal with the E.U. Consequently, it is anticipated that amounts due

will be payable on the dates that would have applied if the U.K. remained an E.U. Member State.

Nonetheless, the U.K. government has commissioned the National Audit Office to investigate the basis of the divorce bill, with instructions to pay particular attention to the assumptions and methodologies used to calculate the amount due.

Northern Ireland

Another stumbling block has been the fate of the border between Northern Ireland, which is part of the U.K., and the independent Republic of Ireland. Post-Brexit, it will be the only land border between the U.K. and the E.U.¹ This is a point not resolved but is more aptly described as “shelved for now.”

With the U.K. as a member of the E.U., both the Republic of Ireland and Northern Ireland belong to the E.U. single market and customs union. They share the same regulations and standards, allowing for a soft or invisible border between the two jurisdictions. Britain’s exit from the E.U. risks a return to a hard border that will be policed, unless both sides retain their present positions in key areas including food, animal welfare, prescription drugs, and product safety.

Early drafts of the agreement between the U.K. and the E.U. called for “no divergence” from E.U. rules that support north-south cooperation. However, this was later changed to “continued alignment,” a formulation that appears to allow for subtle divergences.

The new terminology raised questions about who would oversee the border and how disputes might be resolved. It was also too far a step towards a hard border for soft border proponents in the D.U.P. (the Democratic Unionist Party of Northern Ireland), who are currently propping up Theresa May’s minority government. This gives the D.U.P. an effective veto on Brexit matters.

Neither the Republic nor Northern Ireland wants a hard border. Trade and other links between the two jurisdictions are extremely close.

The British government has two stated ambitions which appear contradictory – leaving the E.U. single market and customs union while having no hard border.

For now, the question of the north-south border remains tenuous. Non-U.K. businesses may, on the optimistic side, view the Republic as the easiest post-Brexit trade portal into the U.K., if indeed there is some form of a soft border. Outside the Republic of Ireland, the E.U. is likely to have a different view of how that border should look.

Citizens’ Rights

The December deal guarantees reciprocal protected rights, post-Brexit, to the three million E.U. citizens currently living in the U.K. and to the more than one million U.K. nationals living in the E.U. A joint document issued by the E.U. and the U.K. states that both U.K. nationals and E.U. citizens can continue “to live, work and study as they currently do under the same conditions as under EU law.” The document also

¹ The border between Gibraltar and Spain has some of the same characteristics but Gibraltar is not part of the U.K. per se.



re-affirms free rights of movement until March 29, 2019, or the actual date on which the U.K. leaves the E.U.

Any E.U. citizen who is in the U.K. on Brexit Day will have the right to remain in the U.K., even if he or she arrives in the U.K. only one day before. Those not yet granted permanent residence in the U.K. will have their rights protected, so they can still acquire permanent residence after Brexit Day. The deal also includes re-unification rights for relatives of E.U. citizens not presently living in the U.K. These rights extend to future spouses or partners of E.U. citizens.

E.U. citizens living in the U.K. will have their rights enshrined in U.K. law and enforced by British courts. The process for giving E.U. citizens residency rights in the U.K. will fall under a new procedure known as settled status. The European Court of Justice will also have jurisdiction over these rights for eight years after Brexit Day. E.U. citizens will enjoy equal access to social security, healthcare, education, and employment. However, they could lose their residence rights if they remain outside the U.K. for five years or more.

U.K. citizens living elsewhere in the E.U. before Brexit Day will have the right to remain in their E.U. Member State of residence. They will be entitled to equal treatment regarding social security, healthcare, employment, and education. However, their freedom of movement will be limited as they will not be able to freely relocate to another E.U. Member State without first applying for a passport in their E.U. country of residence.

Certain rights of U.K. nationals after Brexit Day are currently unclear. These include the absolute rights to move to another E.U. country, work cross-border in the E.U., and receive free emergency medical treatment. Decisions on these items have been deferred to the second round of negotiations.

WHAT HAPPENS NOW?

Unpicking 43 years of treaties and agreements covering thousands of different subjects was never going to be a straightforward task. It has not been done before on this scale, and negotiators will be making the rules as they go along. The post-Brexit trade deal is likely to be the most complex part of the negotiation because it will require the unanimous approval of more than 30 national and regional parliaments across Europe, some of whom may want to hold referendums.

It is worth citing the C.E.T.A. (Comprehensive Economic and Trade Agreement) experience here. This treaty between Canada and the E.U. took seven years to conclude and nearly fell apart with the finish line in sight when the regional parliament of the Belgian province of Wallonia demanded a concession before giving their eventual consent. In the case of C.E.T.A., two areas of local concern jeopardized the approval process. These were use of arbitration panels rather than courts and concern that the treaty could be used as a backdoor entry to the E.U. for U.S. farmers and U.S. farm goods. The former was deleted from the treaty and the latter was addressed by the adoption of stringent standards for Canadian products to prevent indirect competition from the U.S. This illustrates the tenuous and fragile nature of negotiating a trade deal agreement, as it likely will be exclusive more than inclusive in its reach.

Talks are now addressing trade between the U.K. and E.U. after Brexit. These talks

are likely to focus on the terms for a “transition period” of two years or so to smooth the change in relations.

Prime Minister May says leaving the E.U. with no deal would be better than signing the U.K. up to a bad one. Without an agreement on trade, the U.K. may have to resort to operating under World Trade Organization (“W.T.O.”) rules, which could mean customs checks and tariffs on goods as well as longer border checks for travelers. This raises the question of which is more valuable: time and inconvenience costs of no deal or lost revenue arising from a bad deal.

There are questions about Britain’s current position as a global financial center, and the U.K.-Ireland border issue likely will fester.

OUTLOOK FOR U.S. BUSINESSES

The big unknown is negotiation of a trade agreement between the U.S. and the U.K. Presently, the E.U. and the U.S. have the largest bilateral trade and investment relationship and enjoy the most integrated economic relationship in the world. When the U.K. quits the E.U., it will not be part of these arrangements, and the terms of a new relationship must be hammered out with the U.S.

The key body in all of this is the W.T.O. Until Brexit Day, the U.K. is a member via its membership in the E.U. The U.K. will automatically become a member in its own right as soon as it leaves the E.U. Until a new trade deal with the E.U. is reached, trade will be conducted under W.T.O. rules after Brexit Day.

The U.K. is glancing anxiously across the Atlantic at how the U.S. will react to Brexit. President Obama, during his time in office, said the U.K. would need to go “to the back of the line” in trade discussions with the U.S. President Trump appears to have taken a contrary view. The new U.S. ambassador to the U.K., Woody Johnson, insisted the special relationship between the two countries will remain as strong as ever once Britain leaves the E.U. He has stated that the U.K. would always have a “strong and reliable trade partner” in the U.S. regardless of the outcome of Brexit and insisted the ties would not be harmed. “Our position on Brexit is clear. We want a strong and prosperous UK to remain a leader in Europe, and we want both the UK and the EU to remain strong leaders globally.” In comparison to the former president, Mr. Johnson said, “As far as the president is concerned, the United Kingdom, our most enduring ally, is always at the head of the line.” Mr. Johnson also added that the “lure” of working with Britain remains the same today as when his grandfather chose the U.K. to establish the company’s first overseas subsidiary, over 100 years ago. He added:

Our countries are among each other’s largest inward investors. Americans and Brits hold roughly one trillion dollars of investment and employ approximately one million people in each other’s countries — jobs that have increased prosperity and opportunity in all four countries of the United Kingdom and in every American state.

The British government is confident that it will procure a trade deal with the E.U., taking the best elements of deals the E.U. has already concluded with Canada, Japan, and South Korea as examples.

QUO VADIS THE U.K. POST-BREXIT TAX REGIME?

V.A.T., Customs Duties, and Other Indirect Taxes

V.A.T. is chargeable on most goods and service supplies within the E.U. The law is fairly harmonized, although Member States have a degree of discretion over rates and collection methods. In addition, the U.K. has been granted derogations (a European term for exceptions) allowing the zero-rating of certain classes of goods. Customs duties on imports into the single market are also harmonized, and E.U. law prevents taxes being levied on the raising of capital. Indeed, a past attempt to impose a stamp duty charge on certain share issues in the U.K. was ruled contrary to E.U. law.

A departure from the E.U. will simultaneously restore the U.K.'s sovereignty over tax-setting while access to the single market will be limited. Thus, the U.K. will gain the power to overhaul its tax system but its global businesses will become subject to E.U. customs duties unless a beneficial customs arrangement is negotiated.

In one scenario, not much may change. V.A.T. forms a sizeable part of the U.K. government's tax intake and there will be little benefit in deviating significantly from the existing, E.U.-derived system, save perhaps creating further exemptions or rates for particular classes of goods. If the U.K. joins the European Free Trade Association, like Norway or Switzerland, it will benefit from a special customs procedure that suspends customs and excise duties and V.A.T. on goods that pass through the U.K. to an E.U. destination. Further tax reliefs could be negotiated via bilateral trade agreements. The U.K. tax authorities will have more freedom to apply transfer duty to certain share issues, but moves of this kind are unlikely from a practical perspective and would be seen as counter-productive to new investment.

In another scenario, there will be no V.A.T.-free trading area between the U.K. and the remaining Member States. Customs duties may be imposed as goods move between the U.K. and the E.U. This would inevitably bring with it increased paperwork, delays and additional administration.

Until a trade deal is reached, the W.T.O. trade rules will apply. The likely result is higher import duty rates and increased import V.A.T. on imported goods as V.A.T. is calculated on the duty-inclusive value of imports.

Direct Taxes: Company Profits and Capital Gains

Brexit Day will mark the end of the U.K.'s obligations and rights under various E.U. laws designed to reduce the burden of direct tax for companies doing business across the single market. The Parent-Subsidiary Directive simplifies profit distributions between E.U. group companies by preventing double taxation and abolishing withholding taxes on dividend payments. The Mergers Directive simplifies the reorganization of groups based in more than one E.U. Member State, while the Interest and Royalties Directive removes withholding taxes on intra-E.U. interest and royalty payments between associated companies. All of these directives are enacted via legislation that, from the U.K. side, is likely to remain in place post-Brexit. Additionally, tax treaties have a significant crossover with some of these rules and will remain in place post-Brexit. However, as these tax rules will over time diverge from E.U. rules, taxation will inevitably become more complex and burdensome

“The U.K. will gain the power to overhaul its tax system but its global businesses will become subject to E.U. customs duties unless a beneficial customs arrangement is negotiated.”

for M.N.E.'s that have group companies in both the U.K. and E.U. The U.K. will also lose its protection against discriminatory tax measures being imposed by E.U. Member States, putting it at risk of a tougher commercial environment and eroding the strategic benefit for investors of locating intermediate holding companies in the U.K. The U.K. will be free, in turn, to amend its direct tax legislation to create a more competitive environment. But substantial divergence from the E.U. system might make the U.K. less attractive to inward investors and reduce its leverage in negotiations with the E.U., so is unlikely to happen. Further, an emphasis on global trade, rather than European trade, will ease burdens to some degree.

There are proposals within the E.U. to consolidate corporate taxes further. A proposed Anti-Tax Avoidance Directive was agreed on June 21, 2016 and the E.U.'s proposed consolidated corporate tax base has reared its head again. The U.K. is generally against such further integration, so leaving the E.U. will have a potential benefit in this respect. The reality is, however, that most U.K. groups either have substantial interests in other E.U. Member States or trade with such states. E.U. measures will therefore continue to have relevance after Brexit.

The U.K.'s 19% corporation tax rate (with the government's stated intention to reduce it further in April 2020 to 17%) is the lowest among the G-20 nations. The U.K. also has a favorable holding company regime. It boasts the world's most extensive Double Tax Agreement network with dividends paid by underlying non-U.K. subsidiaries subject to, in many countries, nil or reduced withholding taxes. Dividend income received by U.K. companies is generally tax-free. And lastly, on the subject of dividends, these are paid out by a U.K. company free of any U.K. withholding tax to shareholders anywhere in the world, be they companies, trusts, foundations, or individuals. Additionally, U.K. holding companies benefit from favorable capital gains tax legislation for companies wishing to divest themselves of subsidiaries (the "Substantial Shareholding Exemption"). In most instances, this results in a zero-tax bill on the gain on disposal.

LIKELY UPSIDES

Although Brexit brings much uncertainty, there are potential positives:

- The U.K. is a member of the G-20, O.E.C.D., and W.T.O. independently from its membership in the E.U. It will thus continue to be a party to Double Tax and other agreements that have their basis in these international organizations. Indeed, a departure from the E.U. will give the U.K. more freedom over the method and pace of its implementation of the O.E.C.D.'s B.E.P.S. project, and other large-scale harmonizing initiatives.
- E.U.-wide measures can make Member States less competitive and create dual levels of accountability (e.g., the proposed Anti-Tax Avoidance Directive, which includes a General Anti-Abuse Rule requiring Member States to meet certain minimum anti-abuse requirements). The U.K. has objected to proposals to harmonize corporation tax rules (the Common Consolidated Corporate Tax Base) and to introduce a new investor-state dispute resolution system (the Investment Court System), which would apply to all future E.U. agreements. If investors balk at measures of this kind, the U.K. might be viewed as an attractive host state by virtue of no longer being subject to them.

IN CONCLUSION

Much water remains to flow under the Brexit bridge. Hence, it is difficult to prognosticate life after Brexit Day. Any advice given will undoubtedly be driven by whether a hard or soft Brexit is likely to occur. The signs right now suggest that a soft Brexit is the more likely scenario, but the scenario can change overnight.

The conclusion of a favorable trade deal with the E.U. will be a major driver. Both the E.U. and the U.K. stand to gain from continuing the mutually beneficial trading environment, and there is significant interdependence that benefits both sides of the English Channel. A good example is the motor industry. Britain assembles several well-known car models, and in doing so, many parts are imported from the E.U. Will the U.K. government really seek to charge V.A.T. and duties on such parts, thereby making the cars more expensive to sell and putting a significant number of jobs at risk? Will the E.U. impose duties on the importation of such cars from the U.K. by E.U. distributors?

Equally important, will a post-Brexit world bring with it a more benign or more complex business environment in the U.K.? Will the banks desert the U.K. as a major world financial center, accompanied by the exit of many high earning executives taking their tax payments to other countries? What about Scotland, which voted in to remain in the E.U.? It is now faced with a Brexit it doesn't want, and its first minister has campaigned vigorously for Scotland's right to retain post-Brexit access to the E.U. single market. ("If a special case can be made for Northern Ireland, why not for us?")

Finally, petty local interests may intervene, attempting to stake out non-competition areas regarding certain parts of trade. Farmers, dairies, and energy are notable examples. They may also demand mandatory use of forums in home countries to resolve trade disputes.

There are so many questions and unknowns. The best advice for now, to those businesses considering the U.K. as a trading or investing partner, may well be to refrain from making any knee-jerk decisions, to keep a close watch on developments, and to act soonest thereafter. Basing a business decision on tenuous assumptions now may lead to a discovery that the assumptions were groundless and prove to be unnecessarily expensive. On the other hand, missing the boat to relocate a business close to a market may itself be expensive if the lost opportunity cannot be regained.

While this may reflect a certain amount of fence-sitting, it may prove better in the long run than coming down irretrievably on the wrong side.



QUALIFIED BUSINESS INCOME – ARE YOU ELIGIBLE FOR A 20% DEDUCTION?

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Tags

Deductions
T.C.J.A.
Qualified Business Income
("Q.B.I.")

INTRODUCTION

The Tax Cuts and Jobs Act ("T.C.J.A."), signed into law on December 22, 2017, contained several major changes with respect to individuals and entities. This article discusses a new provision allowing individuals, trusts, and other non-corporate taxpayers¹ to claim a deduction equal in amount to 20% of the "qualified business income" and certain other income from business, subject to certain ceilings.

This new provision is programmed to sunset for taxable years beginning after December 31, 2025, but it may be repealed earlier, depending on the results of the next presidential election, or extended on a rolling basis beyond the sunset date, as has happened for certain provisions in the area of Subpart F. It applies to both U.S. persons and non-U.S. persons, generally as long as the income relates to a "qualified" U.S. business.

Like many other provisions of the T.C.J.A., the qualified business income deduction was drafted with only limited public input that took place during a relatively short period of time. It clearly is designed to distinguish between businesses carried on in non-corporate form that employ many people in skilled and non-skilled positions and personal services businesses where owner-managers provide the key skill sets for generating profit. Business owners in the former group should be able to qualify for the benefit. Regrettably, business owners in the latter group tend to look like employees in this context, and it is unlikely that they will obtain the full benefit.

Aside from revealing broad policy objectives, a simple reading of the statute will shed little light on the business income that qualifies for the deduction. One reason is the drafting style of the statute, which hides important concepts in unusual ways. As a result, a full understanding of the winners and losers under this provision requires a thorough deconstruction of the statute. In order to achieve clarity, this article is written in question and answer format that logically guides the reader through the provisions and does not hide the results among new terms defined in hidden subdivisions of subsections.

ENTITLEMENT TO THE DEDUCTION

Taxpayers Entitled to the Code §199A Deduction

Q. 1: Can every taxpayer take the Code §199A deduction?

No. Only taxpayers other than C corporations can take the deduction.²

¹ Forthcoming regulations are expected to discuss the application of the provision to tiered partnership structures.

² Code §199A(a).

Q. 2: Can non-U.S. taxpayers take the Code §199A deduction?

Yes. Both U.S. and non-U.S. taxpayers can take the deduction if they otherwise qualify.

Income Benefitting from the Code §199A Deduction

Q. 3: What type of taxable income must a taxpayer generate in order to benefit from the Code §199A deduction?

Each of the following types of income may benefit from the deduction:

- Qualified cooperative dividends
- Qualified R.E.I.T. dividends
- Qualified publicly traded partnership income
- Qualified business income³

Q. 4: What is a cooperative and what are qualified cooperative dividends?

A cooperative is any organization that is exempt from tax under Code §521, which relates to farmers' cooperatives. It also includes any taxable corporation that operates on a cooperative basis and allocates amounts to patrons on the basis of the business done with or for such patrons.⁴ Examples are grain, citrus, and dairy businesses. These corporations are allowed a deduction for patronage dividends and per-unit retain allocations.

Qualified cooperative dividends are certain amounts received by patrons from cooperatives.⁵ They include a patronage dividend, any per-unit retain allocation, and any qualified written notice of allocation. In this way, the cooperative and its patrons split income: The patron is taxed on the qualified dividends received from the cooperative, and the cooperative is taxed on its taxable income in excess of qualified cooperative dividends paid.

A patron is any person with whom or for whom the cooperative association does business on a cooperative basis. A patronage dividend is an amount paid to a patron under a valid enforceable written obligation that is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons. A per-unit retain allocation means any allocation to a patron with respect to products marketed for the patron where the amount is fixed. These payments are also deductible.

Q. 5: What is a R.E.I.T. and what are qualified R.E.I.T. dividends?

In broad terms, a R.E.I.T. (real estate investment trust) is a domestic corporation or association that is focused exclusively on the ownership, operation, financing, and

³ To facilitate a clear understanding of the provisions, these categories are discussed in order from simplest computations to most complex.

⁴ Code §1381(a)(2). Certain organizations are excluded from treatment as a cooperative. These include mutual savings banks and insurance companies and rural electrical and telephone companies.

⁵ Code §199A(e)(4).

“To the extent dividends are paid, the R.E.I.T. pays no tax and the shareholders are deemed to derive long-term capital gains or ordinary income.”

sale of real estate. If several conditions are met,⁶ a R.E.I.T. is entitled to deduct distributions to shareholders,⁷ and the shareholders report the dividend as having the character of the underlying earnings of the R.E.I.T. Thus, if the earnings arise from rental operations or mortgage financing operations, the dividends produce ordinary income in the hands of shareholders. On the other hand, if the earnings arise from the sale of real estate and are designated as a capital gain distribution, the distribution is taxed under rates for long-term capital gains.⁸ In this manner, a R.E.I.T. is not tax transparent, but to the extent dividends are paid, the R.E.I.T. pays no tax and the shareholders are deemed to derive long-term capital gains or ordinary income.

Qualified R.E.I.T. dividends are dividends received during the taxable year from a R.E.I.T. other than the following:⁹

- Dividends designated as capital gain dividends by a R.E.I.T. and thus benefiting from capital gain treatment, as provided for under Code §857(b)(3)
- Qualified dividend income as defined under Code §1(h)(11), which benefits from long-term capital gains tax rates for individuals rather than ordinary income rates

Thus, a qualified R.E.I.T. dividend is a dividend that arises from operating revenue of the R.E.I.T. and is taxed at ordinary income rates.

Q. 6: What is a publicly traded partnership and what is qualified publicly traded partnership income?

In general, partnerships, including limited liability companies (“L.L.C.”), are not subject to tax on their income.¹⁰ Instead, they are treated as tax transparent entities and conduits to partners.¹¹ Items of taxable or tax-exempt income, gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability, even if no distribution is made to partners.

Certain partnerships are treated as corporations, even if no “check-the-box” election is made. These partnerships are known as “publicly traded partnerships.”¹² A partnership is a publicly traded partnership if interests in the partnership are traded on an established securities market or readily tradable on a secondary market. Typically, a partnership must have at least 100 partners to meet the readily-tradeable test.

An exception from corporate treatment is provided for certain publicly traded partnerships where 90% or more of gross income is “qualifying income.”¹³ Qualifying income is defined to include the following:

- Interest

⁶ Code §§856-860.

⁷ Code §857(b)(3)(B).

⁸ *Id.*

⁹ Code §199A(e)(3).

¹⁰ Code §701.

¹¹ Code §702(a).

¹² Code §7704(a).

¹³ Code §7704(c).

- Dividends
- Gains from the disposition of a capital asset (or of property described in Code §1231(b)) that is held for the production of income that is qualifying income
- Rents from real property
- Gains from the sale or other disposition of real property (including real estate held for sale to customers in the ordinary course of business)
- Income and gains from (i) the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or marketing of any mineral, natural resource (including fertilizer, geothermal energy, and timber), or industrial-source carbon dioxide or (ii) the transportation or storage of certain fuel mixtures, alternative fuel, alcohol fuel, or biodiesel fuel
- Income and gains from commodities, futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contract

If corporate treatment is not mandated for a publicly traded partnership because it meets the 90% test, a 20% Code §199A deduction may be available for the following items:

- The net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss that is effectively connected with a U.S. trade or business and included or allowed in determining taxable income for the taxable year
- Gain recognized by the taxpayer on the disposition of its interest in the partnership that is treated as ordinary income (e.g., by reason of Code §751)

Note that, as further explained in the answer to Q. 8, below, the deduction does not cover all income that would otherwise be qualified income for a publicly traded partnership. Thus, investment-type income, reasonable compensation, guaranteed payments for services, or Code §707(a) payments for services (to the extent provided in I.R.S. regulations) are excluded.

Q. 7: What is qualified business income (“Q.B.I.”)?

Q.B.I. is essentially income, gain, deduction, or loss that is effectively connected to a qualified trade or business.¹⁴ The income must be recognized and taken into account in determining taxable income for the year. For this purpose, the principles of Code §864(c) are applied when determining whether income is effectively connected with a qualified trade or business.¹⁵

Q. 8: What types of income are excluded from the definition of Q.B.I.?

Certain types of income are explicitly excluded from the definition of Q.B.I. They fall into three broad categories.

¹⁴ Code §199A(c)(3)(A).

¹⁵ Code §199A(c)(3)(A)(i).

Items in the first category are covered elsewhere and may qualify for the deduction based on their own tests:

- Qualified cooperative dividends¹⁶
- Qualified R.E.I.T. dividends¹⁷
- Qualified publicly traded partnership income¹⁸

Items in the second category relate broadly to investment income and gains:

- Any short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss¹⁹
- Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in Code §954(c)(1)(G)²⁰
- Any interest income other than interest income that is properly allocable to a trade or business²¹
- Any item of gain or loss relating to certain commodities transactions or foreign currency gains²²
- Any item of income, gain, deduction, or loss relating to currency gains and losses that are not considered to be hedges of business-related currency risks²³
- Any amount received from an annuity which is not received in connection with the trade or business²⁴
- Any item of deduction or loss properly allocable to a previously described amount²⁵

Items in the third category relate broadly to compensation arrangements involving a business conducted as an S-corporation or partnership, including an L.L.C.:

- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business²⁶
- Any guaranteed payments to a partner for services rendered with respect to



¹⁶ Code §199A(c)(1).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Code §199A(c)(3)(B)(i).

²⁰ Code §199A(c)(3)(B)(ii).

²¹ Code §199A(c)(3)(B)(iii).

²² Code §199A(c)(3)(B)(iv).

²³ Code §199A(c)(3)(B)(v).

²⁴ Code §199A(c)(3)(B)(vi).

²⁵ Code §199A(c)(3)(B)(vii).

²⁶ Code §199A(c)(4)(A).

the trade or business²⁷

- To the extent provided in regulations, any payment described in Code §707(a) to a partner not acting in its capacity as partner for services rendered with respect to the trade or business²⁸

Definition of Qualified Trade or Business

Q. 9: What is a qualified trade or business?

A qualified trade or business is any trade or business other than (i) the trade or business of performing services as an employee or (ii) the performance of a specified service trade or business (“S.S.T.B.”).²⁹

Q. 10: How is an employee distinguished from an independent contractor that is conducting a business?

There are several areas of tax law in which the status of an individual as an employee or independent contractor must be determined in order to arrive at a proper tax result. In the international tax field, the distinction may control whether a permanent establishment exists when the individual is providing services to a resident of a country with which the U.S. has an income tax treaty. It also may control whether an individual resident of that country is taxed on compensation income from the performance of services in the U.S. In the domestic context, the determination controls whether the person paying the compensation must withhold income and social security taxes from payments.

While the domestic fact pattern is much more mundane than the cross-border complexities of treaties and permanent establishments, the rules are relatively well developed and I.R.S. guidance exists. Moreover, in the domestic context, the payer is based in the U.S. and has its own obligations and its own exposure to noncompliance penalties. Hence, the domestic rules distinguishing between an employee and an independent contractor likely provide helpful guidance until such time as I.R.S. regulations are published. When regulations are published, they may follow to a greater or lesser extent existing rules regarding employer withholding obligations in the domestic context.

Section 2 of I.R.S. Publication 15-A, *Employer’s Supplemental Tax Guide*, addresses the question of whether a service provider is an employee or an independent contractor. It provides the following view of the I.R.S., beginning on page 7:

Common Law Rules

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence

²⁷ Code §199A(c)(4)(B).

²⁸ Code §199A(c)(4)(C).

²⁹ Code §199A(d)(1).



fall into three categories: behavioral control, financial control, and the type of relationship of the parties. These facts are discussed next.

Behavioral control. Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of: Instructions that the business gives to the worker.

Instructions that the business gives to the worker. An employee is generally subject to the business' instructions about when, where, and how to work. . . . The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. . . .

Training that the business gives to the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. . . .

The extent of the worker's investment. An independent contractor often has a significant investment in the facilities or tools he or she uses in performing services for someone else. . . .

The extent to which the worker makes his or her services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. . . .

The extent to which the worker can realize a profit or loss. An independent contractor can make a profit or loss.

Type of relationship. Facts that show the parties' type of relationship include:

- ***Written contracts describing the relationship the parties intended to create.***
- ***Whether or not the business provides the worker with employee-type benefits, such as insurance, a pension plan,***

vacation pay, or sick pay.

- ***The permanency of the relationship. . . .***
- ***The extent to which services performed by the worker are a key aspect of the regular business of the company.***

Other more practical indicia of running a business rather than being an employee include the following:

- Business stationary with a mailing address, e-mail domain name, and telephone number that have no connection to those of the client
- Using the foregoing contact points in written, digital, and telephonic correspondence with the client
- Paying health insurance premiums for coverage that is not part of the client's group insurance plan
- Terminating participation in the client's pension plan and establishing a separate self-employed pension plan that is totally funded by the service provider
- Having more than one client or multiple clients that are all commonly owned or related
- Purchasing equipment, computer programs, and data base access that are used to provide services to the client
- Obtaining an I.R.S. employer identification number for the business

Q. 11: What is the definition of an S.S.T.B.?

S.S.T.B. is the term used to describe persons who are not employees and who principally practice a consulting service or profession. Depending on the circumstances, these persons can operate from a small independent base or a large, global organization. The definition of S.S.T.B. is based on the definition of "qualified trade or business" for purposes of the qualified small business stock exclusion of Code §1202.³⁰ Under that Code section, if the business (i) is a qualified trade or business, (ii) is carried on in corporate form, and (iii) meets certain tests, individual shareholders are allowed an exclusion when shares of the corporation's stock are sold at a gain.³¹ For purposes of the Q.B.I. deduction, the following qualified trades or businesses for purposes of Code §1202 constitute S.S.T.B. if they are carried on as a sole proprietorship, partnership, or S-corporation:³²

- Health
- Law
- Accounting

³⁰ See discussion in ["Qualified Small Business Stock & the EB-5 Visa Program – An Attractive Combination for Potential Investors,"](#) *Insights* 6 (2017).

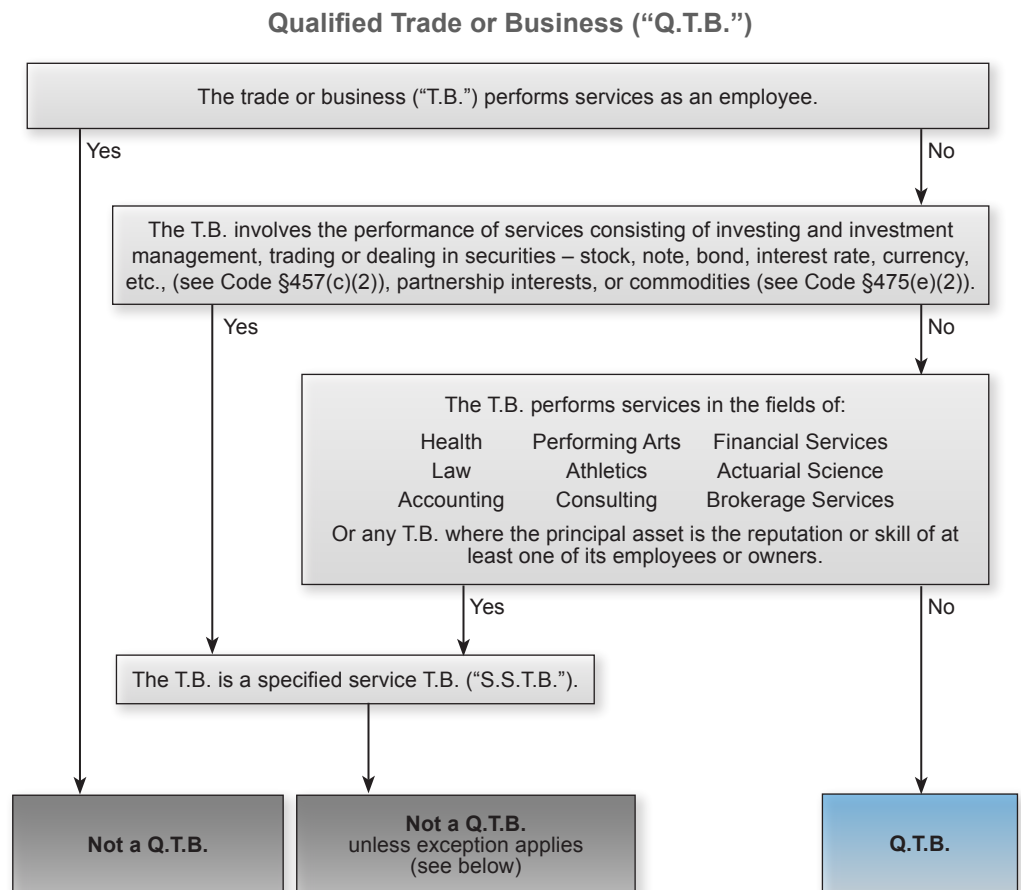
³¹ Code §1202(a) provides the exclusion. Code §1202(e)(3) lists businesses that are characterized as qualified trades or businesses. These businesses are similar but not identical to those listed under Code §199A.

³² Engineering and architectural services are listed in Code §1202(e)(3) but are removed from categorization as S.S.T.B.'s.

- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees³³

Also included as S.S.T.B.'s are service businesses that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities, which typically must use a mark-to-market accounting method that results in gain recognition if the value of the securities inventory appreciates as of the close of the year.³⁴

The following flowchart illustrates the definitions of qualified trade or business and S.S.T.B.



³³ A business that takes into account the reputation or skill of the owners in addition to employees does not appear in the list under Code §1202(e)(3).

³⁴ Code §475.

“A trade or business would not be a qualified trade or business when (i) the owner has a skillset that is brought to the business and (ii) the skillset itself is not unique to the owner but (iii) the reputation for quality is unique and is valued by the customers.”

Q. 12: Does Code §199A provide an explanation as to when the principal asset of a trade or business is the reputation or skill of one or more of its employees?

No. However, the reference by Code §199A(d)(2)(A) to Code §1202(e)(3)(A), relating to qualified small business stock, coupled with the absence of guidance under Code §199A, should allow taxpayers to usefully rely on guidance issued under Code §1202(e)(3)(A). The same standard should apply to owners of the business carried on as a sole proprietorship, partnership, or S-corporation.

In Private Letter Ruling 201717010 (the “P.L.R.”),³⁵ a C-corporation (the “Taxpayer”) provided laboratory results to clients in the healthcare industry. The Taxpayer’s employees were trained for up to a year to perform the testing upon which the laboratory results were based. The skills the employees brought with them at the time they were hired by the Taxpayer were of almost no use when performing the testing activities. Further, the skills the employees acquired were unique to the work they performed for the Taxpayer and of no use to other employers. The I.R.S. thus concluded that the Taxpayer was not in a trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

Until regulations or other guidance are issued by the I.R.S., this fact pattern may prove useful if the references to employees are broadened to include owners of a business and the references to other employers are broadened to include customers.

By extrapolation, a trade or business would not be a qualified trade or business when (i) the owner has a skillset that is brought to the business and (ii) the skillset itself is not unique to the owner but (iii) the reputation for quality is unique and is valued by the customers. While such a business would not be a qualified trade or business, it may be an S.S.T.B. and still give rise to a limited deduction as explained below.

Q. 13: For purposes of Code §199A, why is it not always bad for a business to be categorized as an S.S.T.B.?

While it is better, for the purposes of the deduction, for an individual to conduct a qualified trade or business, conducting an S.S.T.B. may still allow an individual a limited Code §199A deduction based on a simplified formula. This limited deduction is available up to a threshold amount and is discussed below.

COMPUTATION OF THE DEDUCTION

In General

Q. 14: How is the Q.B.I. deduction computed?

Until the I.R.S. publishes regulations or other guidance, the best way to understand the computation of the Q.B.I. deduction is to deconstruct the statute, giving attention to each element of the deduction. The sum of these elements is the amount of the deduction.

³⁵

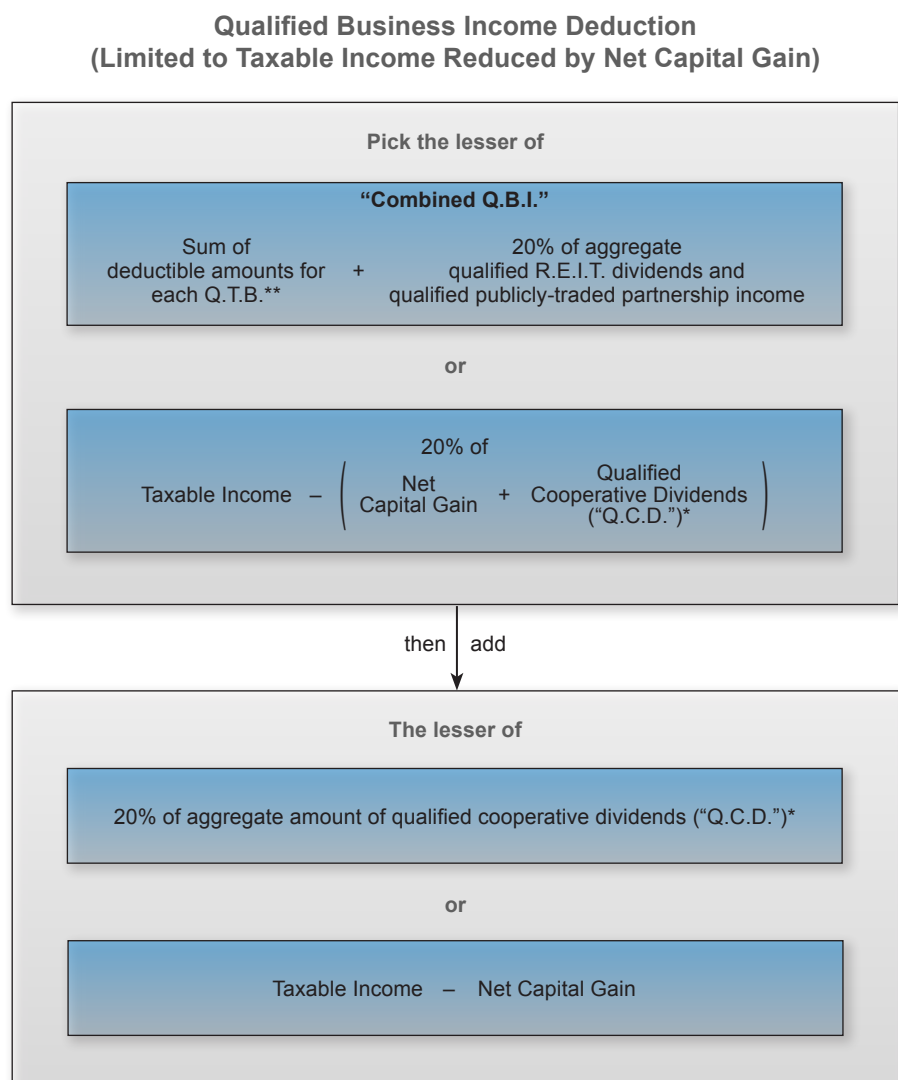
PLR 201717010, 04/28/2017.

Q. 15: What elements comprise the Code §199A deduction?

As mentioned above, four separate streams of income can result in the Code §199A deduction:

- Qualified cooperative dividends
- Qualified R.E.I.T. dividends
- Qualified publicly traded partnership income
- Q.B.I.

Each is discussed separately, and the following diagram is a useful reference for purposes of understanding the deduction.



* Paid by certain tax exempt entities and cooperatives under subchapter T.

** See next diagram

Qualified Cooperative Dividends

Q. 16: In general, how is the Code §199A deduction for qualified cooperative dividends computed?

As discussed above, qualified cooperative dividends consist of patronage dividends, any per-unit retain allocations, and any qualified written notice of allocations. The amount of the Code §199A deduction for these items is 20% of the amount received, capped at the taxpayer's taxable income, net of capital gains.³⁶ When the deduction for qualified cooperative dividends is added to combined Q.B.I., the total deduction is capped by the individual's taxable income for the year, excluding net capital gains. This is discussed below in greater detail.

Q. 17: If, after paying qualified cooperative dividends to patrons, a cooperative has taxable income, is the cooperative entitled to a Code §199A deduction?

Yes. A special rule exists for specified agricultural and horticultural cooperatives under which a Code §199A deduction may be claimed by the cooperative. This type of cooperative may deduct 20% of the amount by which its gross income exceeds qualified cooperative dividends paid during the year.³⁷

However, the deduction is capped at the greater of 50% of the W-2 wages of the cooperative with respect to its trade of business or 25% of the W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property of the cooperative.

Q. 18: What cooperatives are entitled to claim the Code §199A deduction?

A cooperative is entitled to claim the Code §199A deduction if it is a specified agricultural or horticultural cooperative. This means that it is a taxable cooperative under the rules of Subchapter T of the Code and is engaged in any of the following businesses:

- The manufacture, production, growth, or extraction in whole or significant part of any agricultural or horticultural product
- The marketing of agricultural or horticultural products that its patrons have manufactured, produced, grown, or extracted
- The provision of supplies, equipment, or services to farmers or to organizations described in the foregoing bullet points³⁸

Qualified R.E.I.T. Dividends

Q. 19: In general, how is the Code §199A deduction relating to qualified R.E.I.T. dividends determined?

The rules covering the deduction for qualified R.E.I.T. dividends appear in the

³⁶ Code §199A(a)(2).

³⁷ Code §199A(g)(1)(A).

³⁸ Code §199A(g)(3).

“The deduction for combined Q.B.I. and qualified cooperative dividends cannot exceed the taxpayer’s taxable income for the year, computed by excluding net capital gain.”

definition of the term “combined Q.B.I. amount.”³⁹

The Code §199A deduction for qualified R.E.I.T. dividends is 20% of the amount of the qualified dividend received by the shareholder. As discussed previously in the answer to Q. 5, qualified R.E.I.T. dividends do not include capital gain dividends paid by the R.E.I.T. and dividends that are covered by Code §1(h)(11).⁴⁰ Both those dividends are taxed at favorable long-term net capital gains tax rates.

In the first instance, no cap is placed on the amount of the deduction. However, when 20% of qualified R.E.I.T. dividends are added to the sum of the deductible amounts for each qualified trade or business and to 20% of qualified publicly traded partnership income to arrive at combined Q.B.I. amount, as discussed below, the deductible amount cannot exceed 20% of the taxable income of the taxpayer for the year. This cap is computed without taking into account net capital gain income and qualified cooperative dividends.

As alluded to above and discussed in more detail below, the deduction for combined Q.B.I. and qualified cooperative dividends cannot exceed the taxpayer’s taxable income for the year, computed by excluding net capital gain.⁴¹

Qualified Publicly Traded Partnership Income

Q. 20: In general, how is the Code §199A deduction for qualified publicly traded partnership income determined?

The rules covering the deduction for publicly traded partnership income appear in the definition of the term “combined Q.B.I. amount,” which supplements the general definition provision of Code §199A.⁴²

As discussed in the answer to Q. 6, a publicly traded partnership is generally treated as a corporation for U.S. income tax purposes unless 90% or more of its gross income is qualifying income.

Several categories of income can be qualifying income, including interest; dividends; certain gains; rents from real property; gains from the sale or other disposition of real property; income and gains from the exploration, development, mining, or production of natural resource; and income and gains from commodities or futures contracts and the like.

In computing the Code §199A deduction relating to qualified publicly traded partnership income, only the partnership’s Q.B.I. (as defined in the answer to Q. 7) is taken into account. Concepts of effectively connected income are used to determine how much of the partnership income is qualified. Passive income and compensation-related income are excluded when computing the deduction.

When the qualified publicly traded partnership income is determined, 20% of that amount is added to 20% of the aggregate qualified R.E.I.T. dividends, discussed

³⁹ Code §199A(g)(1)(B).

⁴⁰ Code §199A(e)(3).

⁴¹ Code §199A(a), last sentence.

⁴² Code §199A(b)(1)(B) and (e)(5).

above, and to the deductible amount for each qualified trade or business, discussed below, to arrive at the combined Q.B.I. amount. As alluded to above, when the combined Q.B.I. amount is added to the deduction for the qualified cooperative dividend, the aggregate deduction cannot exceed the taxable income of the taxpayer for the year. Again, the cap is computed by excluding net capital gain income and qualified cooperative dividends.

Q.B.I.

Q. 21: In general, how is the part of the Code §199A deduction relating to Q.B.I. computed?

This part of the Code §199A deduction is referred to in the Code as “the deductible amount for each qualified trade or business” (“D.A.Q.T.B.”). For simplicity, this article uses the term “Tentative Q.B.I. Deduction.”

For each qualified trade or business, the deduction is computed in several steps.⁴³ The initial step is straightforward. The Q.B.I. for each business is multiplied by 20%, and the result is the Tentative Q.B.I. Deduction. Then, limitations are applied to this result. These limitations are designed to ensure that the deduction benefits an active trade or business with substantial headcount or long-term investment in property, plant, and equipment.

The first limitation subjects the amount of the deduction to two ceilings.⁴⁴ One is based on wages paid. The other only applies if the first ceiling is exceeded.

Under the first ceiling, the Q.B.I. deduction cannot exceed 50% of the W-2 wages paid with respect to the qualified trade or business. This is beneficial for a labor-intensive business.

Under the second ceiling, the deduction cannot exceed the sum of (i) 25% of the W-2 wages paid with respect to the qualified trade or business plus (ii) 2.5% of the unadjusted basis of all qualified property immediately after acquisition. Stated differently, the latter amount is 2.5% of the all-in cost of the property, based on a snapshot on the date of acquisition. Qualified property consists of property, plant, and equipment held at the close of the taxable year and for which the depreciable period has not ended before the close of the year. The depreciable period cannot exceed ten years from the date the property was first placed into service by the taxpayer.⁴⁵ This second ceiling is beneficial to a capital-intensive business. Accelerated write-off provisions enacted as part of T.C.J.A. will not reduce the benefit under this ceiling.

Additional limitations apply to the way the Tentative Q.B.I. Deduction interplays with the first and second ceiling amounts. These limitations are discussed later in this article under Q. 23.

The following flowchart illustrates the two ceilings.

⁴³ Code §199A(a).

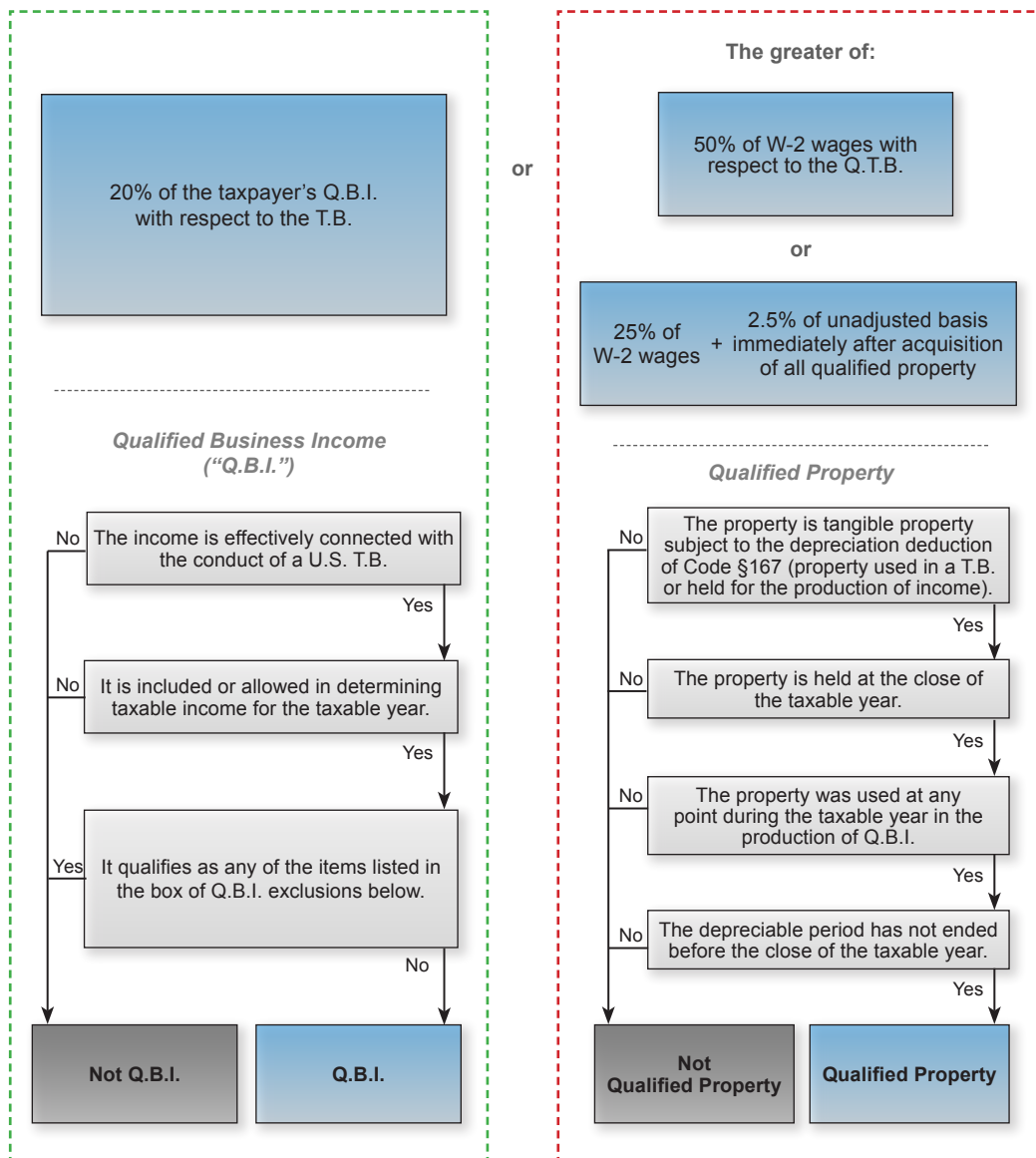
⁴⁴ Code §199A(b)(2)(B)

⁴⁵ Code §199A(b)(6).



Deductible Amount for Each Q.T.B. ("D.A.Q.T.B.")

The deductible amount is the lesser of:



Q.B.I. Exclusions

- Qualified R.E.I.T. dividends
- Qualified cooperative dividends
- Qualified publicly traded partnership income
- Any short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss
- Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in Code §954(c)(1)(G)
- Any interest income other than interest income which is properly allocable to a trade or business
- Any item of gain or loss relating to certain commodities transactions or foreign currency gains
- Any item of income, gain, deduction, or loss relating to certain notional principal contracts
- Any amount received from an annuity which is not received in connection with the trade or business
- Any item of deduction or loss properly allocable to a previously described amount
- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business
- Any guaranteed payments to a partner for services rendered with respect to the trade or business
- To the extent provided in regulations, any payment described in Code §707(a) to a partner not acting in capacity as partner for services rendered with respect to the trade or business

At this point, a third limitation (mentioned several times above) comes into play. The qualified R.E.I.T. dividends and qualified publicly traded partnership income, if any, are added to the capped Q.B.I. deduction to arrive at the combined Q.B.I. amount. The sum of the deductions for combined items is then capped so that it cannot exceed 20% of the taxable income of the taxpayer for the year, computed by excluding net capital gain income plus qualified cooperative dividends.⁴⁶

Finally, the fourth limitation is applied. The deduction for the combined Q.B.I. amount and 20% of the qualified cooperative dividends⁴⁷ cannot exceed, in the aggregate, the taxpayer's taxable income for the year, net of capital gains.⁴⁸

Q. 22: Do all wages qualify as W-2 wages?

No. W-2 wages are defined as follows:

- The wages must constitute remuneration paid for services performed by an employee for the benefit of the employer with respect to employment during the calendar year (as defined in Code §3401(a)) or certain employee retirement fund payments (as defined in Code §§402(g)(3), 457, 402A) with respect to employment during the calendar year.⁴⁹
- The wages must be reported to the Social Security Administration on a Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements*.⁵⁰
- The Forms W-2 and W-3 reporting such wages must be filed by the 60th day after the due date (including extensions) for such returns.⁵¹ This requirement essentially encourages taxpayers to pay close attention to their employment tax compliance. Most importantly, it encourages employers to (i) determine precisely what payments constitute wages for employment tax purposes and (ii) properly differentiate between independent contractors and employees. Any long-term non-compliance may adversely affect the taxpayer's Q.B.I. deduction.
- The wages must be allocable to qualified business income.⁵²
- The wages cannot constitute any of the following:⁵³
 - Reasonable compensation paid to the taxpayer by any S-corporation that is a qualified trade or business of the taxpayer for services

⁴⁶ Code §199A(a)(1).

⁴⁷ Capped by the taxpayer's taxable income net of capital gains.

⁴⁸ Code §199A(a), last sentence.

⁴⁹ Code §199A(b)(4)(A).

⁵⁰ Code §199A(b)(4)(C).

⁵¹ *Id.*

⁵² Code §199A(b)(4)(B).

⁵³ Code §199A(b)(4)(B) as referencing to Code §199A(c)(1) and Code §199A(c)(4) for the definition of "qualified business income" of Code §199A(c)(1).

rendered with respect to the trade or business⁵⁴

- Any guaranteed payments to a partner for services rendered with respect to the trade or business⁵⁵
- To the extent provided in regulations, any payment described in Code §707(a) to a partner not acting in its capacity as a partner for services rendered with respect to the trade or business⁵⁶

The following example illustrates the computations and limitations:

- Mrs. X is the sole owner of X L.L.C., which manufactures widgets for sale. X L.L.C. employs several employees and pays them wages in an aggregate amount of \$800,000. X L.L.C. has ordinary income of \$5,000,000, and the machinery and other property used in its business has an unadjusted basis of \$2,000,000 at the time of purchase and a depreciable life greater than ten years. Further, Mrs. X has no qualified cooperative dividends, qualified R.E.I.T. dividends, qualified publicly traded partnership income, or net capital gain.
- Mrs. X is entitled to a deduction computed as follows:
 - Tentative Deduction: 20% of her taxable income attributable to the Q.B.I. of X L.L.C. = \$1,000,000⁵⁷
 - First Ceiling Amount: 50% of the W-2 wages = \$400,000⁵⁸
 - Second Ceiling Amount: 25% of the W-2 wages (\$200,000)⁵⁹ + 2.5% of the unadjusted basis of property (\$50,000)⁶⁰ = \$250,000
- Mrs. X is thus entitled to a deduction of \$400,000 (i.e., the amount of the Tentative Q.B.I. Deduction capped at the greater of the first and second ceiling amounts).

Additional Limitations

Q. 23: What are the additional limitations that apply when computing the Code §199A deduction relating to Q.B.I.?

Individuals who are not employees under the standard set forth above can benefit from the Code §199A deduction in a relatively uncomplicated way if their taxable income does not exceed a certain threshold.

For persons who are unmarried, an S.S.T.B. entrepreneur can claim the full 20%

⁵⁴ Code §199A(c)(4)(A).

⁵⁵ Code §199A(c)(4)(B).

⁵⁶ Code §199A(c)(4)(C).

⁵⁷ \$5,000,000 x 20%

⁵⁸ 50% x \$800,000

⁵⁹ 25% x \$800,000

⁶⁰ 2.5% x 2,000,000

“As the taxpayer’s income increases within the clawback corridor, more and more of the benefit of the 20% Q.B.I. deduction is lost.”

Tentative Q.B.I. Deduction,⁶¹ provided that taxable income does not exceed a threshold amount.⁶² Consequently, as long as the individual’s total taxable income is within the threshold amount, the ceilings based on (i) 50% of W-2 wages or (ii) 25% of W-2 wages and 2.5% of capital investment in property, plant, and equipment are not applicable. For such individuals, the threshold amount is \$157,500 of total taxable income reported in an unmarried individual’s tax return.

If the individual is married and files a joint return with a spouse, the threshold amount is \$315,000. Again, the individual’s business must not be characterized as employment based on the standards described the answer to Q. 10. The threshold amount is adjusted annually for inflation.

Once the threshold amount is breached, Code §199A benefits under the simplified method for those with taxable income under the threshold are clawed back on a ratable basis over a specified range. The intent is to eliminate the benefit of the simplified method entirely when the clawback range is fully used.

For an unmarried individual with taxable income in excess of \$157,500, the entire benefit is clawed back on a ratable basis as total taxable income reaches \$207,500. The clawback range is \$50,000.

If the individual is married, the clawback begins when total taxable income exceeds \$315,000, and the entire benefit is eliminated when total taxable income reaches \$415,000 in the joint return. The clawback range for married individuals is \$100,000.

As the taxpayer’s income increases within the clawback corridor, more and more of the benefit of the 20% Q.B.I. deduction is lost. When income reaches the top of the corridor, the ceilings apply in full, achieving the same result as if the ceilings would have been applied in the first place.

The clawback is determined by reducing the Tentative Q.B.I. Deduction by the amount obtained using the following formula:

$$\left(\begin{array}{cc} \text{Tentative} & \text{First or Second} \\ \text{Q.B.I. Deduction} & \text{Ceiling} \end{array} - \right) \times \frac{\text{Taxable Income} - \$157,500}{\$50,000}$$

Q. 24: How does the clawback formula work in an actual fact pattern?

The clawback is illustrated in the following examples.

Example 1

- Mrs. X, a married individual filing a joint income tax return with her spouse, Mr. X, is the sole owner of X L.L.C., a manufacturer of widgets. X L.L.C. employs two individuals and pays total wages of \$50,000. X L.L.C. has ordinary taxable income of \$300,000, and the machinery and other property used in its business has an unadjusted basis of \$20,000. Mrs. X has no qualified

⁶¹ Code §199A(b)(3)(A).

⁶² Code §199A(b)(3)(B).

cooperative dividends, qualified R.E.I.T. dividends, qualified publicly traded partnership income, or net capital gain. Mr. X has no income.

- Mrs. X's threshold amount is \$315,000, since she is filing a joint tax return with her spouse. Mrs. X's taxable income is below the income threshold, and she is entitled to a deduction computed as follows:
 - Tentative Deduction: 20% of the \$300,00 taxable income attributable to the Q.B.I. of X L.L.C. = \$60,000
 - First Ceiling Amount: 50% of the \$50,000 of W-2 wages = \$25,000
 - Second Ceiling Amount: 25% of the \$50,000 of W-2 wages (\$12,500) + 2.5% of the unadjusted basis of property (\$500) = \$13,000
- Mrs. X is entitled to a deduction of \$60,000 under the simplified method, because the ceilings do not apply. Were they applicable, her deduction would have been \$25,000. As a result, the benefit of the simplified method is \$35,000.

Example 2

- Across the street from the widget premises of X L.L.C., Mr. Y maintains a shop, Y L.L.C., that manufactures super widgets. Y L.L.C. has two employees who are paid wages in an aggregate amount of \$50,000. Y L.L.C. has ordinary taxable income of \$300,000, and the machinery and other property used in its business has an unadjusted basis of \$20,000. Further, Mr. Y has no qualified cooperative dividends, qualified R.E.I.T. dividends, qualified publicly traded partnership income, or net capital gain. Additionally, Mrs. Y is a kindergarten teacher with an annual salary of \$100,000.
- Mr. Y's threshold amount is \$315,000, since he is filing a joint return with his spouse. Mr. Y's upper phase-in limit is \$415,000 (*i.e.*, \$315,000 + \$100,000).
- Because Mr. Y's income is within the clawback corridor, Mr. Y is entitled to a deduction computed as follows:
 - Tentative Deduction: 20% of the \$300,000 taxable income attributable to the Q.B.I. of X L.L.C. = \$60,000
 - First Ceiling Amount: 50% of the \$50,000 of W-2 wages = \$25,000
 - Second Ceiling Amount: 25% of the \$50,000 of W-2 wages (\$12,500) plus 2.5% of the unadjusted basis of property (\$500) = \$13,000
- Mr. Y would have been entitled to a deduction of \$60,000 had the total taxable income on his tax return been under \$315,000. However, because his total taxable income exceeds the threshold but not the \$100,000 clawback corridor, his deduction is equal to \$25,000 under the first ceiling plus a portion of the \$35,000 difference between the \$60,000 Tentative Q.B.I. Deduction and the \$25,000 amount under the first ceiling.
- Mr. Y's total taxable income exceeds the threshold amount by \$85,000 (*i.e.*,

\$400,000 - \$315,000). Applying the formula described above, the \$35,000 benefit for being under the threshold is multiplied by a fraction to determine the clawback:

- $\$35,000 \times (\$85,000 \div \$100,000) = \$ 29,750$
- The remainder of \$5,250 is added to \$25,000, and the Code §199A deduction under the phaseout is \$30,250.

S.S.T.B.

Q. 25: What benefit is derived when an individual who is not an employee is engaged in an S.S.T.B.?

When an individual who is not an employee is engaged in an S.S.T.B., he or she may be eligible for the Q.B.I. deduction on a simplified basis, provided that income remains at a relatively low level.

In principle, logical consistency suggests that a highly successful individual who is engaged in a consulting business would not be someone whose net income is relatively low. While a successful businessperson can hire staff, employ people, and maximize W-2 wage income, providing that person with a tax break may not be good politics.

On the other hand, providing a *sub rosa* tax break to someone beginning a consulting business who scrapes to make ends meet while following his or her dream likely has wider political appeal. Thus, the logic may be bad in respect of the Q.B.I. deduction, but the politics are good.

First, the individual's taxable income must be above the specified amount but not in excess of the high end of the clawback corridor. Second, the Tentative Q.B.I. Deduction and the two ceiling amounts are reduced by the following percentage:

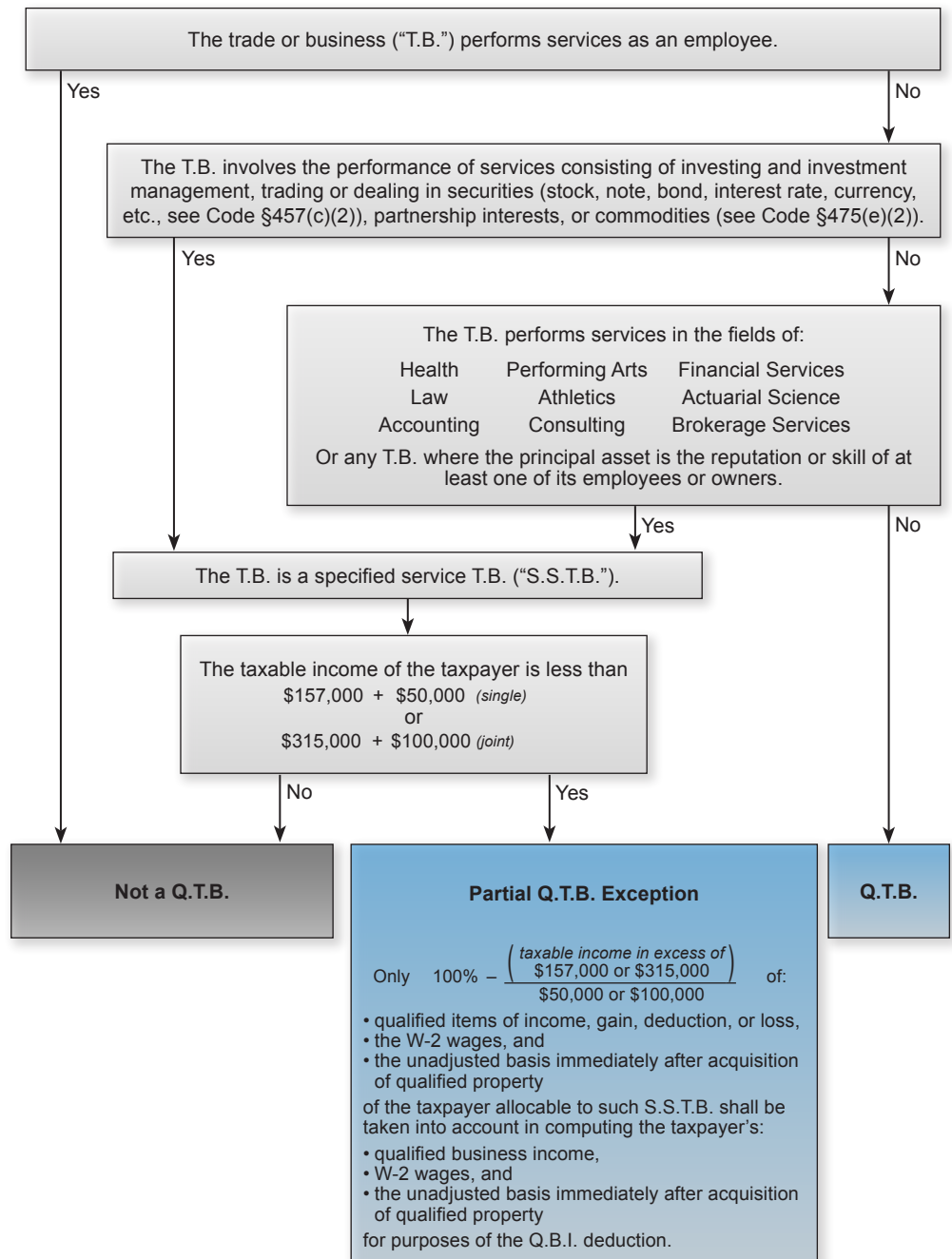
$$100\% - \left(\frac{\text{the amount of income actually within the clawback corridor}}{\text{the full amount of the clawback corridor}} \right)$$

As previously mentioned, the corridor is \$50,000 for single individuals and \$100,000 for married individuals filing a joint return. This corridor begins at \$157,500 for a single individual and \$315,000 for married individuals filing a joint return.

The flowchart on the following page best describes the above:



Exception for Certain Specified Service Trades or Businesses



Q. 26: How does the limited benefit for S.S.T.B. work in an actual fact pattern?

The limited benefit for S.S.T.B is illustrated in the following example.

- Mrs. Z is the founding partner of P.L.L.C. Z, a law firm. Mrs. Z is the only partner and P.L.L.C. Z has two employees that are paid wages in an aggregate amount of \$50,000. P.L.L.C. Z has ordinary taxable income of \$400,000, and no machinery and other property is used in its business. Further, Mrs. Z has no qualified cooperative dividends, qualified R.E.I.T. dividends, qualified

“The I.R.S. will issue regulations or a notice that will provide official guidance.”

publicly traded partnership income, or net capital gain. Finally, Mr. Z, her husband, is unemployed.

- Mrs. Z’s threshold amount is \$315,000. Since she files a joint return with her spouse. Mrs. Z’ upper phase-in limit is \$415,000 (*i.e.*, \$315,000 + \$100,000).
- Because Mrs. Z’s income is greater than the threshold amount but not in excess of the phase-in limit, Mrs. Z is entitled to a limited deduction computed as follows:
 - Applicable Percentage: $100\% - 85\% = 15\%$
 - This calculation is based on the following factors:
 - Total income within the clawback corridor = \$85,000 (*i.e.*, \$400,000 - \$315,000)
 - Total amount of the corridor = \$100,000
 - Tentative Deduction: $15\% \times 20\%$ of the \$400,000 taxable income attributable to the S.S.T.B. = \$12,000
 - First Ceiling Amount: $15\% \times 50\%$ of the \$50,000 of W-2 wages = \$3,750
 - Second Ceiling Amount: $15\% \times 25\%$ of the \$50,000 of W-2 wages (\$1,875) + 2.5% of the unadjusted basis of property (\$0) = \$1,875
- Mrs. Z would have been entitled to a deduction of \$12,000 had the total taxable income on her tax return been under \$315,000. However, because her total taxable income exceeds the threshold but not the \$100,000 clawback corridor, her deduction is equal to \$3,750 under the first ceiling plus a portion of the \$8,250 difference between the \$12,000 Tentative Q.B.I. Deduction and the \$3,750 amount under the first ceiling (see Q. 24, Example 2).
- Mrs. Z’s total taxable income exceeds the threshold amount by \$85,000 (*i.e.*, \$400,000 - \$315,000). Applying the formula described above, the \$8,250 benefit for being under the threshold is multiplied by a fraction to determine the clawback:
 - $\$8,250 \times (\$85,000 \div \$100,000) = \$ 7,012.50$
 - The remainder of \$1,237.50 is added to \$3,750, and the Code §199A deduction under the phaseout is \$4,987.50.
- Mrs. Z would have been entitled to a deduction of \$33,250 had P.L.L.C. Z’s activity not been an S.S.T.B. As a result of her S.S.T.B., her deduction is limited to \$4,987.50. If Mrs. Z and her husband’s taxable income exceeds \$415,000, they would lose the benefit of the deduction, absent any qualified R.E.I.T. dividends, qualified publicly traded partnership interest, or qualified cooperative dividends.

CONCLUSION

At some point, the I.R.S. will issue regulations or a notice that will provide official guidance. Congress may also revisit the provision to rewrite in a more understandable way. In the interim, this article has attempted to provide structure to the unstructured approach of the statute, following a step-by-step method to explain the application of the Q.B.I. deduction. In so doing, it has focused on principles that apply to each element of the deduction.

B.E.A.T.-ING BASE EROSION: U.S. SUBJECTS LARGE CORPORATIONS TO ANTI-ABUSE TAX

Authors

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Tags

Base Erosion
Base Erosion & Anti-Abuse
Tax (“B.E.A.T.”)
Excise Tax
Tax Reform
T.C.J.A.

The Tax Cuts and Jobs Act (“T.C.J.A.”) introduced Code §59A, which imposes a new Base Erosion and Anti-Abuse Tax (“B.E.A.T.”) on large corporations that significantly reduce their U.S. tax liability through the use of cross-border payments to related persons. The provision is viewed to be an act against inbound base erosion as well as another form of the now-repealed corporate Alternative Minimum Tax.

B.E.A.T. HITS BIG BUSINESS

The B.E.A.T. generally applies to corporate taxpayers that have average annual gross receipts of \$500 million or more during the testing period (the “gross receipts test”) and whose deductible payments to related parties (“base erosion payments”) equal or exceed 3% of their total allowed deductions (2% for certain banks and securities dealers). The provision does not apply to S-corporations, regulated investment companies (“R.I.C.’s”) or real estate investment trusts (“R.E.I.T.’s”).

The B.E.A.T. is not limited to U.S. corporations but can apply to foreign corporations as well with respect to income that is effectively connected with the conduct of a U.S. trade or business. However, for purposes of determining whether the foreign corporation meets the gross receipts test, gross receipts are only included if they are taken into account when calculating the taxpayer’s U.S. effectively connected income.

If the base erosion payments reduce the taxpayer’s U.S. tax liability to less than 10% of its U.S. (modified) taxable income, the B.E.A.T. applies. The definition of base erosion payment is open ended and includes, *inter alia*, payments for services, interest, rents, and royalties.

CALCULATING THE TAX LIABILITY

If applicable, the amount of the B.E.A.T. is determined by a formula that compares 10% of the modified gross income with the actual tax paid by the taxpayer. A positive result is the B.E.A.T. amount. Modified gross income is generally arrived at by adding back to the taxable income (i) any deductions allocated to base erosion payments or (ii) depreciation and amortization related to property whose purchase was treated as a base erosion payment, as well as (iii) a certain portion of the deducted net operating loss.

In 2018 the calculation of the B.E.A.T. takes into account a 5% rate of tax. After 2025, the calculation takes into account a 12.5% rate of tax. These rates are 1% higher for certain banks and securities dealers.

The “add-back” deductions are those attributable to base erosion payments, which

generally mean deducted amounts paid or accrued by the taxpayer to a related foreign person. For these purposes, a foreign person is related to the taxpayer if the person is (i) treated as owning at least 25% of the shares entitled to the vote or the value in the taxpayer, (ii) related to the taxpayer or to a 25% owner within the meaning of Code §267, or (iii) treated as related under principles applicable to the transfer pricing rules of Code §482. For purposes of determining the relationship, constructive ownership rules apply.

Certain payments are excluded. These include the following:

- Payments that reduce the taxpayer's gross receipts, such as payments for the cost of goods sold (except for certain expatriated corporations)
- Payments for services that are eligible for the application of the services cost method under the transfer pricing regulations
- Payments subject to U.S. withholding tax under the rules applicable to fixed determinable annual or periodic ("F.D.A.P.") payments¹

If interest deductions are limited by Code §163(j), the reduction in the deduction amount is allocable first to interest on loans from unrelated parties. When comparing the calculated amount of tax to the actual tax liability, certain general and industry specific business credits are added back, increasing the likelihood that the B.E.A.T. will apply.

PLANNING ISSUES AND OPPORTUNITIES

Deductible F.D.A.P. payments that are actually subject to U.S. withholding tax are generally excluded from the calculation of the B.E.A.T. amount. However, the provision does not address other payments that are subject to U.S. tax (e.g., payments to related controlled foreign corporations that may be treated as Subpart F that are included in the U.S. shareholder's taxable income and payments to U.S. branches outside the U.S.). In this respect, a Treasury official, speaking at an International Tax Institute meeting in N.Y., stated that the provision was intended not only as an anti-base erosion provision but also as a minimum tax provision. It is therefore possible that further guidance will not amend this seeming omission. However, we are to await and see.

Following the enactment of this provision, large corporations should analyze the deductible payments made to related foreign persons and determine if the B.E.A.T. is a concern. While potential restructuring of payments can be explored, the Treasury has been granted broad regulatory authority to issue regulations to prevent the avoidance of the B.E.A.T., including the use of unrelated persons. According to the Treasury official, regulations should be published by June 2019 and will apply retroactively to January 1, 2018.

¹

Code §871 imposes tax on F.D.A.P. income received by nonresident individuals; Code §881 imposes tax on F.D.A.P. income received by foreign corporations; Code §§1441 and 1442 provide for the withholding of the tax imposed under the aforementioned provisions.



NON-CORPORATE TAXATION: INDIVIDUALS & PARTNERSHIPS FACE HIGHS & LOWS UNDER THE T.C.J.A.

Author
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Tags
Individual Tax Rates
Like-Kind Exchange
Partnerships
Tax Reform
TCJA

The Tax Cuts and Jobs Act (“T.C.J.A.”) brought many changes for non-corporate taxation, changing tax rates and repealing many popular deductions. Several changes in the partnership provisions corrected what lawmakers considered to be loopholes.

INDIVIDUAL TAX REFORM

Individual Rate Reform

The individual tax brackets have been reduced and modified up to the year 2025. The personal exemption has been temporarily suspended, and the standard deduction has been temporarily increased to \$24,000 for married individuals filing jointly, \$18,000 for heads of households, and \$12,000 for all other individuals. The standard deduction is not available to nonresident aliens.

Here is a comparison of the old and new individual income tax rates:

Single Taxpayers

Prior Law		T.C.J.A.	
Income Bracket	Tax Liability	Income Bracket	Tax Liability
\$0 - \$9,325	10%	\$0 - \$9,525	10%
\$9,325 - \$37,950	\$932.50 + 15% over \$9,325 but not over \$37,950	\$9,525 - \$38,700	\$952.50 + 12% over \$9,525 but not over \$38,700
\$37,950 - \$91,900	\$5,226.25 + 25% over \$37,950 but not over \$91,900	\$38,700 - \$82,500	\$4,453.5 + 22% over \$38,700 but not over \$82,500
\$91,900 - \$191,650	\$18,713.75 + 28% over \$91,900 but not over \$191,650	\$82,500 - \$157,500	\$14,089.5 + 24% over \$82,500 but not over \$157,500
\$191,650 - \$416,700	\$46,643.75 + 33% over \$191,650 but not over \$416,700	\$157,500 - \$200,000	\$32,089.5 + 32% over \$157,500 but not over \$200,000
\$416,700 - \$418,400	\$120,910.25 + 35% over \$416,700 but not over \$418,400	\$200,000 - \$500,000	\$45,689.5 + 35% over \$200,000 but not over \$500,000
Above \$418,400	\$121,505.25 + 39.6% over \$418,400	Above \$500,000	\$150,689.5 + 37% over \$500,000

“The individual tax brackets have been reduced and modified up to the year 2025.”

Married Individuals Filing Jointly

Prior Law		T.C.J.A.	
Income Bracket	Tax Liability	Income Bracket	Tax Liability
\$0 - \$18,650	10%	\$0 - \$19,050	10%
\$18,650 - \$75,900	\$1,865 + 15% over \$18,650 but not over \$75,900	\$19,050 - \$77,400	\$1,905 + 12% over \$19,050 but not over \$77,400
\$75,900 - \$153,100	\$10,452.5 + 25% over \$75,900 but not over \$153,100	\$77,400 - \$165,000	\$8,907 + 22% over \$77,400 but not over \$165,000
\$153,100 - \$233,350	\$29,752.5 + 28% over \$153,100 but not over \$233,350	\$165,000 - \$315,000	\$28,179 + 24% over \$165,000 but not over \$315,000
\$233,350 - \$416,700	\$52,222.5 + 33% over \$233,350 but not over \$416,700	\$315,000 - \$400,000	\$64,179 + 32% over \$315,000 but not over \$400,000
\$416,700 - \$470,700	\$112,728 + 35% over \$416,700 but not over \$470,700	\$400,000 - \$600,000	\$91,379 + 35% over \$400,000 but not over \$600,000
Above \$470,700	\$131,628 + 39.6% over \$470,700	Above \$600,000	\$161,379 + 37% over \$600,000

Married Individuals Filing Separate Returns

Prior Law		T.C.J.A.	
Income Bracket	Tax Liability	Income Bracket	Tax Liability
\$0 - \$9,325	10%	\$0 - \$9,525	10%
\$9,325 - \$37,950	\$932.50 + 15% over \$9,325 but not over \$37,950	\$9,525 - \$38,700	\$952.50 + 12% over \$9,525 but not over \$38,700
\$37,950 - \$76,750	\$5,226.25 + 25% over \$37,950 but not over \$76,750	\$38,700 - \$82,500	\$4,453.5 + 22% over \$38,700 but not over \$82,500
\$76,750 - \$116,675	\$14,876.25 + 28% over \$76,750 but not over \$116,675	\$82,500 - \$157,500	\$14,089.5 + 24% over \$82,500 but not over \$157,500
\$116,675 - \$208,350	\$26,111.25 + 33% over \$116,675 but not over \$208,350	\$157,500 - \$200,000	\$32,089.5 + 32% over \$157,500 but not over \$200,000
\$208,350 - \$235,350	\$56,364 + 35% over \$208,350 but not over \$235,350	\$200,000 - \$300,000	\$45,689.5 + 35% over \$200,000 but not over \$300,000
Above \$235,350	\$65,814 + 39.6% over \$235,350	Above \$300,000	\$80,689.5 + 37% over \$300,000

Foreign Income Tax Deduction

Prior Law

Previously, individuals were allowed deductions for certain taxes paid or accrued, even if they were not incurred in the individual's trade or business. This included state, local, and foreign property, income, war profits, and excess profits tax.

T.C.J.A.

Now, state, local, and foreign property taxes and state and local sales taxes are only deductible when paid or accrued in carrying on a trade or business or in association with an investment expense under Code §212.

Foreign income taxes paid may only be deducted under Code §164(b)(6)(B) as part of an aggregate deduction for (i) state and local real property taxes, (ii) state and local personal property taxes, and (iii) state, local, and foreign income taxes, which is limited to \$10,000 unless the taxes were paid or accrued in carrying on a trade or business or a Code §212 expense. Note that taxpayers generally chose to claim a foreign tax credit in lieu of a deduction, so this change as it relates to foreign income taxes may have little impact.

Limitation on Deduction of Foreign Taxes¹

Foreign Income Taxes		Foreign Real Property Taxes	
Prior Law	T.C.J.A.	Prior Law	T.C.J.A.
<ul style="list-style-type: none">No limitation on the deduction of foreign income taxes.	<ul style="list-style-type: none">Business expenses are deductible without limitation, <i>i.e.</i>, when income is reported on Schedule C, E, or F.Any other foreign income tax is limited to \$10,000, <i>e.g.</i>, income tax paid on interest earned from foreign investments, reported on Schedule B.	<ul style="list-style-type: none">No limitation on the deduction of foreign income taxes.	<ul style="list-style-type: none">GR: Not deductibleException: Deductible without any limitation if incurred in carrying on a trade or business

Alimony Deduction

Prior Law

Alimony and separate maintenance payments were deductible by the payor and includible in income by the recipient.

T.C.J.A.

Alimony and separate maintenance payments are no longer deductible by the payor spouse nor included in income by the recipient. The provision will become effective for any divorce or separation instrument executed or modified after 2018.

¹ Applicable until tax year 2025. Code §164(b)(6) as amended by §11042 of the T.C.J.A.



Estate and Gift Tax

Under current and prior law, gift tax is imposed on lifetime gifts, while estate tax is imposed on transfers made at death. Gifts and bequests are generally excluded from the recipients' gross income.

A unified credit is available to taxable gifts and bequests.² The amount of the exemption used to offset lifetime gifts reduces the amount available at time of death. The top marginal tax rate of 40% is imposed on gifts and estates for transfers in excess of \$1 million after the exemption has been utilized. A 40% generation-skipping transfer tax may also be imposed on transfers exceeding the exemption to a recipient more than one generation younger than that of the transferor.

Prior Law

The amount exempted from tax was set at \$5 million and increased for inflation to \$5.49 million for 2017.

T.C.J.A.

The T.C.J.A. roughly doubles the estate and gift tax exemption for tax years after 2017 and before 2026. The amount for 2018 is \$11.18 million. The Secretary shall prescribe regulations with respect to differences between the exclusion amount at the time of decedent's death and any gifts made before that date.

PARTNERSHIPS

Prior Law

Technical Termination

A partnership was considered technically terminated if, within a 12-month period, there was a sale or exchange of 50% or more of the total partnership interests. There was a deemed contribution of all of the partnership's assets and liabilities to a new partnership in exchange for an interest and a deemed distribution of the interests to the new and remaining partners.³ A technical termination generally terminated the partnership's election and restarted depreciation but did not end its existence.

Substantial Built-In Loss

The transfer of a partnership interest did not result in an adjustment of basis unless a Code §754 election was made or there was substantial built-in loss with respect to the interest transferred. A substantial built-in loss was created if the partnership's adjusted basis in the partnership property exceeded the fair market value of the property by more than \$250,000.

Carried Interest Rule

A profits interest, also known as a carried interest, in a partnership is a right to receive profits in exchange for services. Under a safe harbor rule, the receipt of

² Code §2010.

³ Treas. Reg. §1.708-1(b)(4).

such interest was not a taxable event to the taxpayer if the carried interest entitled the holder only to a share in the gains and profits after the date of issuance.⁴ If the interest related to a substantially certain and predictable stream of income from partnership assets, the partner disposed of the interest within two years of receipt, or the interest was a limited partnership interest in a publicly traded partnership, the safe harbor would not apply. Capital gains from asset sales at the partnership level passed through to all partners, including those receiving a carried interest, generally resulting in taxation to the partners at more favorable rates.

T.C.J.A.

Technical Termination

Under the new law, the Code §708(b)(1)(B) technical termination is repealed. This means a partnership only terminates if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Substantial Built-In Loss

Substantial built-in loss requiring the adjustment of partnership bases has been expanded under the T.C.J.A. to include either (i) the partnership's adjusted basis in the partnership exceeding the fair market value of the property by \$250,000 or (ii) a loss allocation of more than \$250,000 to the transferee if the partnership assets were sold at fair market value for cash immediately after the loss.⁵

Carried Interest Rule

The T.C.J.A. provides a three-year holding period for long-term capital gain with respect to "applicable partnership interests."⁶ The three-year holding period is required for both the taxpayer's interest in the partnership and the partnership's interest in asset(s) sold.

An applicable partnership interest is any interest that is transferred to or held by the taxpayer for the taxpayer or a related party's performance of substantial services in any applicable trade or business.⁷ This does not include a partnership interest held by a corporation or a capital interest with the right to share in the partnership capital for the amount contributed.⁸ Partnerships covered under the new rule are essentially investment partnerships and real estate partnerships, with some exceptions.

LIKE-KIND EXCHANGES

Like-kind exchanges are a popular transactions utilized by individuals and partnerships to defer tax on property exchanges. The new law has significantly curtailed this technique.

⁴ Rev. Proc. 93-27 (1993-2 C.B. 343).

⁵ Code §743(d)(1).

⁶ Code §83.

⁷ Code §1061(c)(1).

⁸ Code §1061(c)(4).

“The like-kind exchange nonrecognition rule is limited and now only applies to real property that is not held primarily for sale or exchange for other real property.”

Prior Law

An exchange of property is generally considered a taxable event. However, no gain or loss was recognized on property held for productive use in a trade or business or for investment if it was exchanged for property that was “like-kind” and to be held in a similar manner and for a similar purpose.⁹ This exception did not apply to stocks considered inventory, partnership interests, trust certificates, or foreign property.¹⁰ Additionally, the nonrecognition rule did not apply to an exchange of one class or kind of property for another and did not recognize losses either.

The basis of property received will be equal to the basis of the property transferred and increased by any gain recognized or decreased by any other property received.¹¹ The holding period received includes the holding period transferred on qualifying property.¹²

The property received in the exchange must be received no more than 180 days after the date on which the original property is relinquished. The taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the relinquished property.¹³

T.C.J.A.

Under the T.C.J.A., the like-kind exchange nonrecognition rule is limited and now only applies to real property that is not held primarily for sale or exchange for other real property. As before, real property cannot be exchanged for another class of property. The different classes are depreciable tangible property, intangible or non-depreciable property, and real property. Improved and unimproved property of the same class is considered like-kind. The rules relating to the transfer of real property, as well as the basis and holding period requirements, remain unchanged. As under prior law, U.S. real property cannot be exchanged for foreign real property, or vice versa.

CONCLUSION

There are clear winners and losers under the T.C.J.A. Clearly, real estate investors have been afforded the continuing ability to make tax-free like-kind exchanges. The doubling of the lifetime exemption will afford wealthy individuals an even greater ability to transfer wealth to younger generations. Several former loopholes in the partnership area have been closed or the rules tightened. Lastly, the new rules relating to alimony may have real-world impact by making divorce more expensive.

⁹ Code §1031(a)(1).

¹⁰ Code §1031.

¹¹ Code §1031(d).

¹² Code §1223(1).

¹³ Code §1031(a)(3).

A NEW OPPORTUNITY FOR NONRESIDENT ALIENS – OWNERSHIP IN AN S-CORP

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Tags

Foreign Ownership
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Trusts

INTRODUCTION

Changes to U.S. tax law brought about by the 2017 Tax Cuts and Job Act¹ (“T.C.J.A.”) have affected many longstanding tax planning tools. One favorable change amends the rules regarding the persons who can own shares of an S-corporation. Historically, the S-corporation election was terminated if a foreign individual became an owner. Under the T.C.J.A., a foreign individual may now utilize an Electing Small Business Trust (“E.S.B.T.”) to obtain an interest in an S-corporation.

BENEFITS OF S-CORPORATION INVESTING

Similar to limited liability companies (“L.L.C.’s”), S-corporations are pass-thru entities whose corporate income, losses, deductions, and credits flow through to their shareholders for Federal tax purposes.²

The S-corporation is a creature of Federal tax law. Any corporation that meets certain hurdles can elect S-corporation status. In comparison, L.L.C.’s are creatures of state company law. The state law controls the rights and powers of the entity formed under the L.L.C. statute. I.R.S. regulations recognize an L.L.C. as a pass-thru entity.

Under the rules applicable to an S-corporation, a shareholder’s deduction for corporate losses is limited to the sum of the shareholder’s adjusted basis in the S-corporation stock and the shareholder’s adjusted basis of any debt issued by the S-corporation to the shareholder.³ Losses not allowed by reason of this limitation generally are carried forward by the corporation to the succeeding year.⁴

Generally, the tax basis in the stock of the S-corporation is (i) increased by the items of S-corporation income attributable to shares owned by the shareholder and passed through to the shareholder’s personal tax return and (ii) decreased by corporate distributions, losses, and deductions attributable to the shareholder’s interest.⁵ In this manner, an S-corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder’s basis in the stock of the corporation.

As opposed to a partner in an L.L.C., a shareholder in an S-corporation can be paid a salary in addition to the flow through of income and gains. Indeed, if the

¹ Pub. L. No. 115-97.

² Code §§1363, 1366.

³ Code §1366(d)(1).

⁴ Code §1366(d)(2).

⁵ Code §1367.

shareholder works in the business, he or she will be treated as receiving a reasonable amount of compensation even if none is paid. That salary is subject to social security taxes for the corporation and the employee-shareholder.

LIMITATIONS ON INVESTORS

To make an S-corporation election, certain restrictions apply to the make-up of the shareholder group:

- The corporation cannot have more than 100 shareholders.
- There cannot be more than one class of stock.
- The corporation cannot have shareholders other than U.S. citizens or individual residents, certain tax-exempt organizations, and certain trusts and estates.⁶

Regarding the stock restriction, the corporation will be considered to have met this requirement if two classes of shares have all the same economic rights to income and appreciation of assets at the time of liquidation, even if one class has voting rights and the other class has limited rights or no rights at all.⁷ As a result, an S-corporation with two or more shareholders cannot make special allocations to shareholders.⁸

Historically, a trust could be a shareholder of an S-corporation in extremely limited circumstances.⁹ These include the following:

- A grantor trust with a U.S. citizen or resident individual as a grantor
- A grantor trust covered in the preceding bullet once the grantor died (but only for two years)
- A trust receiving stock under a will (but only for two years)
- A trust to control voting power
- A trust established pursuant to an individual retirement account to hold shares in depository institution in limited circumstances

The T.C.J.A. expands the circumstances in which a trust can hold shares in an S-corporation, enabling a nonresident to be a current potential beneficiary if the trust qualifies as an E.S.B.T.¹⁰

WHAT IS AN E.S.B.T.?

An E.S.B.T. is a domestic trust that has following types of beneficiaries:

⁶ Code §1361 (b).

⁷ Code §1361(c)(4); Treas. Reg. §1.1361-1(l)(1).

⁸ Treas. Reg. §1.1361-1(l)(2)(i).

⁹ Code §1361(c)(2).

¹⁰ Code §1361(c)(2)(A)(iv).

“Now, a nonresident, noncitizen individual can be a potential current beneficiary of an E.S.B.T.”

- Individuals
- Estates
- Certain types of charitable organizations¹¹

To be an E.S.B.T., the trust must make a timely election. The election can be made – and remains valid – if no beneficiary acquires an interest in the E.S.B.T. through a purchase.¹² For this purpose, an interest is acquired through a purchase if a cost basis exists for the beneficial interest under Code §1012.¹³

For purposes of the E.S.B.T. election, the concept of a “potential current beneficiary” is important. This term refers to a person who has a present, remainder, or reversionary interest in the trust.¹⁴ The E.S.B.T. and all its potential current beneficiaries are treated as shareholders of the S-corporation.

Under prior law, a nonresident, noncitizen individual was eligible to be a future beneficiary without jeopardizing the status of the corporation as an S-corporation, but if that individual became a potential current beneficiary of the E.S.B.T., the S-corporation risked a loss of status because the nonresident, noncitizen individual was considered to be a shareholder.¹⁵

The T.C.J.A. eliminates this risk. Now, a nonresident, noncitizen individual can be a potential current beneficiary of an E.S.B.T., and that will not be taken into account in determining whether the S-corporation has a nonresident, noncitizen individual as a shareholder.

TAX TREATMENT OF AN E.S.B.T.

Generally, an E.S.B.T. is treated as two separate trusts for tax purposes, the portion of the E.S.B.T. that reflects shares of stock in one or more S-corporation(s) is treated as one trust – the S portion – and the portion reflecting all other assets is treated as a second trust – the non-S portion. However, for administrative purposes, an E.S.B.T. is treated as a single trust.¹⁶

An E.S.B.T. can be both a grantor and a non-grantor trust at the same time. Furthermore, if the E.S.B.T. consists of a grantor trust only in part, the E.S.B.T. will be treated as three separate trusts:

- A grantor portion
- A non-grantor S portion
- A non-grantor non-S portion¹⁷

¹¹ Code §1361(e)(1).

¹² Treas. Reg. §1.1361-1(m). Purchase means any acquisition if the basis of the property is determined under Code §1012.

¹³ Code §1361(e)(1)(C).

¹⁴ Treas. Reg. §1.1361-1(m)(ii).

¹⁵ Treas. Reg. §1.1361-1(m).

¹⁶ Treas. Reg. §1.641(c)-1(a).

¹⁷ Treas. Reg. §1.641(c)-1(b).

The grantor portion of the trust is taxed under the grantor tax rules of Subpart E of the Code.¹⁸ Only the non-grantor S portion of the trust is treated as the shareholder for income tax, basis, and distribution purposes under Code §§1366, 1367, and 1368.¹⁹ Again, note that the ownership of S-corporation shares through an E.S.B.T. that is a grantor trust should not result in the loss of S-corporation status.

Taxation of the S Portion

The S portion of an E.S.B.T. is taxed under Code §641(c). Even though the entire trust qualifies as an E.S.B.T., only that portion of the trust consisting of the S-corporation stock is taxed under Code §641(c). Consequently, the items of income, deduction, and credit of the S portion of an E.S.B.T. are limited to the following:

- Items passed through from the S-corporation pursuant to Code §1366
- Gain or loss from the disposition of the S-corporation stock
- State and local income taxes or administrative expenses allocable to such items²⁰

The S portion of the E.S.B.T. generally is taxed at the highest individual tax rate.²¹

If S-corporation stock is distributed to a beneficiary, the beneficiary takes a carryover basis in the shares received in the distribution. Distributions to the E.S.B.T. from the S-corporation that exceed the basis maintained in the shares of the S-corporation are taxed as a capital gain.²² If an E.S.B.T. owns stock in more than one S-corporation, then items of income, loss, deduction, or credit from all the S-corporations are aggregated for purposes of determining the S portion's taxable income.²³

As stated above, a gain realized by an E.S.B.T. on the sale of shares of S-corporation stock will be allocated to the S portion of the trust.²⁴ However, if income from the sale or disposition of stock in an S-corporation is reported by the trust under the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion.²⁵ Finally, if the E.S.B.T. makes a charitable contribution, the deduction is limited to the non-S portion's gross income. Finally, if the S-corporation stock is donated to the charity, neither the S portion nor the non-S portion may claim a deduction.²⁶

Taxation of the Non-S Portion

The taxable income of the non-S portion of the E.S.B.T. is determined by taking into account all items of income, deduction, and credit to the extent not taken into

¹⁸ Treas. Reg. §1.641(c)-1(c).

¹⁹ Treas. Reg. §1.641(c)-1(d).

²⁰ Code §641(c)(2)(C).

²¹ Treas. Reg. §1.641(c)-1(e).

²² Treas. Reg. §1.641(c)-1(d)(3)(iii).

²³ Treas. Reg. §1.641(c)-1(d)(2)(iii).

²⁴ Treas. Reg. §1.641(c)-1(d)(3)(ii).

²⁵ Treas. Reg. §1.641(c)-1(g)(3).

²⁶ Treas. Reg. §1.641(c)-1(l), Ex. 4.

account by either the grantor portion or the S portion of the trust.²⁷ Whenever state and local income taxes or administration expenses relate to more than one portion of an E.S.B.T., the items are allocated to the relevant portions of the E.S.B.T. and apportioned between them. The allocation is done in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if applied in a manner that is consistent.²⁸

Under prior law, an E.S.B.T. was allowed a charitable contribution deduction at the trust level without any limitation, and the contribution was deemed to come from the non-S portion to the extent it was made out of the non-S portion's gross income.²⁹ Under the T.C.J.A., an E.S.B.T.'s charitable deduction is subject to the limitation that applies to individuals.

CROSS-BORDER PLANNING IMPLICATIONS

The T.C.J.A. adopts a provision that allows a nonresident, noncitizen individual to become a potential beneficiary of an E.S.B.T. without causing an S-corporation to lose its status by having a nonresident, non-citizen as a deemed shareholder. This change in law could have a major impact on, for example, the way Canadian-resident individuals invest in the U.S. C.R. – the tax authority in Canada – has adopted the position that a U.S. L.L.C. is not entitled to treaty benefits as it is not subject to tax in the U.S. and for that reason does not fall within the definition of a resident provided in the treaty.³⁰ As a result, an L.L.C. that is formed in the U.S. can be a resident of Canada for Canadian tax purposes, and the tiebreaker provision of the Canada-U.S. Income Tax Treaty is irrelevant. However, C.R.A. does not take a similar position with regard to S-corporations. Thus, the tiebreaker provision becomes relevant in preventing an assertion of Canadian residence for an S-corporation. Under the tiebreaker provision,³¹ the residence of an otherwise dual-resident entity is allocated, for treaty purposes, exclusively to the country under the laws of which it was formed.



²⁷ Treas. Reg. §1.641(c)-1(g)(1).

²⁸ Treas. Reg. §1.641(c)-1(h).

²⁹ Treas. Reg. §1.641(c)-1(g)(4).

³⁰ Article IV (Residence), paragraph 1 of the Canada-U.S. Income Tax Treaty, which in pertinent part, defines a resident in the following terms:

1. For the purposes of this Convention, the term 'resident' of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature

³¹ *Id.*

CORPORATE MATTERS:

PARTNER REPRESENTATIVES AND THE NEW PARTNERSHIP AUDIT REGIME

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Tags
Audits
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Partnership Representative
Tax Matters Partner

Commencing in January 2018, the I.R.S. began a new centralized audit regime with respect to partnerships. It replaces the concept of a “Tax Matters Partner” with a “Partnership Representative.” Although in our practice we mostly see the impact in connection with limited liability companies (“L.L.C.’s”) – which are taxed as partnerships – the new rules are mandatory (subject to certain opt-out rights) for all partnerships, L.L.P.’s, and L.L.C.’s.

TAX MATTERS PARTNER

Prior to January 1, 2018, when a group formed a multi-member L.L.C. in the U.S., it was required to designate one of the members of the new company as the Tax Matters Partner. For many people outside the U.S., the designation caused concern. Frequently, the members did not want to be on record with the I.R.S. in manner distinct from the entity itself, and often, they did not understand what the title entailed.

The role of the Tax Matters Partner was to essentially represent the partnership in tax matters and to be responsible for ensuring that the entity’s tax returns were prepared and filed correctly. Usually this involved providing documentation to the entity’s accountants. While the Tax Matters Partner could also be involved in managing an audit process, each partner maintained the right to receive separate notice from the I.R.S. with respect to any proposed adjustment and had a separate right of appeal. Given the relatively limited powers of the Tax Matters Partner, partners usually gave little thought to who should be appointed and frequently chose the managing member or the dominant partner.

PARTNERSHIP REPRESENTATIVE

The new rules in part reflect the I.R.S.’s frustration with the obligation to provide each partner with notice of an audit and with the partners’ separate rights to appeal. Whereas under the previous law most operating agreements provided for a Tax Matters Partner to handle audit matters with the I.R.S. if required, under the new rules, any audits will be managed at the partnership level by a Partnership Representative. The Partnership Representative has many more powers than the Tax Matters Partner under the old law.

Commencing on January 1, 2018, unless the partnership is able to elect out of the new rules and actually does so, the I.R.S. will only deal with the Partnership Representative and the individual partners have no right to separately appeal any tax assessment. The Partnership Representative also has the power to take other, non-appealable actions with the I.R.S., including agreeing to settle the total tax liability of all partners.

Additionally, in a significant change, the I.R.S. may now collect tax at the partnership level as a result of a tax audit.

The I.R.S. collects the tax from the partnership in the year of the audit (the “adjustment year”). The assessment of the tax, however, is from an I.R.S. audit performed on a prior year (the “reviewed year”). Note, that if there are ownership changes during these years, the new partners in the adjustment year will essentially pay a tax on additional income derived from the reviewed year when they were not a partner. A partnership may, however, make a “push-out” election whereby any tax liability resulting from an audit is pushed out to the partners.

The new rules also eliminate the concept of notice to individual partners. This means that an audit could commence and be finally determined and, unless the Partnership Representative keeps the other informed, the partners could only learn about the audit when they receive a final notice from the I.R.S. – at which stage the action would be unappealable.

Any person is eligible to serve as a Partnership Representative provided they have a “substantial presence” in the U.S. Substantial presence is defined as

- being available to meet in person with the I.R.S. in the U.S. at a reasonable time and place,
- having a street address in the U.S. and a telephone number where they can be reached during normal business hours, and
- having a U.S. taxpayer identification number.

Whereas a Tax Matters Partner was required to be a partner of the entity he or she represented, a Partnership Representative can be any person, including a non-partner, provided they meet the above substantial presence test. The Partnership Representative may be an entity, but if the partnership chooses an entity, the partnership is required to identify and appoint an individual to act on the entity’s behalf.

ELECTING OUT

Subject to certain eligibility requirements, a partnership will be allowed to elect out of the new system, with the effect that its partners will be governed by the audit rules existing prior to January 1, 2018. The eligibility requirements include that the partnership has less than 100 members (as measured by the number of Schedules K-1 the partnership is required to issue) and that each member is an individual, a deceased partner’s estate, a C corporation, a foreign entity that would be required to be treated as a C-corporation if it were a domestic entity, or an S-corporation. The annual election must include the name and taxpayer identification number of each partner, and each partner must receive notice of the election.

IMPACT ON PARTNERS

Depending on the circumstances, partners should consider whether to revise existing operating agreements to provide for the appointment of a Partnership Representative. Where none of the partners reside in the U.S. a third party may need to be appointed. Any revision to an operating agreement may also need to include

restrictions on the Partnership Representative's powers to take certain actions without consent of the partnership or, at least, notice to the partners.

Given the transfer of discretion regarding the management and settlement of an audit from individual partners to the new Partnership Representative, and because audit adjustments would be reflected in the year an audit is concluded rather than in the year being audited, electing out of the new partnership audit rules is worth consideration. Note that, even if a partnership elects out of the new audit rules, a Partnership Representative must still be appointed. As mentioned earlier, this does, however, require each partner to have, and give to the I.R.S., a tax identification number.



UPDATES & OTHER TIDBITS

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Administrative Procedure
Act (“A.P.A.”)
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T.C.J.A.

STOCK-BASED COMPENSATION EXAMINATIONS ON HOLD PENDING ALTERA APPEAL

In the *Altera*¹ decision issued on July 27, 2015, the U.S. Tax Court struck down 2003 cost-sharing regulations that required the sharing of stock-based compensation (“S.B.C.”) under a cost sharing agreement (“C.S.A.”) with a party under common control for purposes of Code §482. The I.R.S. filed an appeal in the *Altera* case with the Ninth Circuit in February 2016.²

On January 12, 2018, the I.R.S. issued a directive that no new examinations on S.B.C. in qualified C.S.A.’s may be opened pending the issuance of an opinion in the *Altera* appeal.³

However, in the case of an ongoing S.B.C. examination, the taxpayer may agree to extend the statute of limitations until the final determination of the appeal in the *Altera* case. Otherwise, the examination will continue without regard to the directive.

DUTCH ENTICE CORPORATE TAXPAYERS WHILE ABUSIVE PLANNING IS TARGETED

On Friday, February 23, 2017, the Dutch government announced its intention to reduce the corporate tax rate to 21% and to abolish dividend withholding tax within a multinational group. The rate reduction for corporate tax matches the recently adopted U.S. tax rates. The elimination of withholding tax on dividends within a multinational group incentivizes the use of the Netherlands as an entrepot into the E.U. by residents of non-E.U. jurisdictions. Residents of the U.S., China, and possibly the U.K. are potential beneficiaries.

In addition, the Dutch government announced that it will adopt additional substance requirements for Dutch holding companies, financing companies, and licensing companies. Currently substance is demonstrated by having Dutch-resident directors comprise at least one-half the board membership and bookkeeping performed in the Netherlands. When effective, companies must incur salary costs of €100,000 or more and must have office space that is actually used to carry on its functions.

¹ *Altera Corp. v. Commr.*, 145 T.C. 3 (2015)

² See *Altera Update – I.R.S. Files Appeal, Altera & Xilinx Respond* in “Updates & Other Tidbits,” *Insights* 9 (2016).

³ LB&I, *Instructions for Examiners on Transfer Pricing Selection- Cost-Sharing Arrangement Stock Based Compensation*, LB&I-04-0118-005.

Finally, the Dutch government confirmed that the Netherlands will adopt Model A of the C.F.C. rules under the E.U. Anti-Tax Abuse Directive. Model A is similar in approach to the U.S. Foreign Personal Holding Company rules of Subpart F. Certain items of “movable” income or passive income will be included in the tax base of a Dutch resident unless the C.F.C. is actively engaged in a business that generates the types of income covered or the items of tainted income comprise not more than one-third of all income of the C.F.C. Tainted income includes the following:

- Interest
- Royalties
- Dividends
- Capital gains on shares
- Leasing income
- Insurance income
- Banking income
- Re-invoicing income

REVISED CODE §1446(F) TIMELINE

Introduced by the Tax Cuts and Jobs Act, the new Code §864(c)(8) provides that a non-U.S. person’s gain or loss from the disposition of a partnership interest will be treated as effectively connected income to the extent that the partnership would have reported effectively connected income and gain had it sold all of its assets at fair market value. This treatment covers the sale of L.L.C. interests to the extent an L.L.C. is treated as a partnership for U.S. income tax purposes. The new rule applies to exchanges or other dispositions occurring on or after November 27, 2017.

To implement tax collection, new Code §1446(f) provides that the transferee of must withhold 10% of the amount realized by the seller on the sale of a partnership interest unless the transferor can provide an affidavit stating that it is not a foreign person. According to the statute, the withholding obligation applies to sales, exchanges, or other dispositions occurring on or after December 21, 2017.

Holders of partnership interests have loudly complained that applying new Code §1446(f) without further guidance is unfairly problematic when the partnership interest is publicly traded. In that fact pattern, the purchaser cannot determine whether the transferor is foreign or domestic when the interests are held by brokers, generally in street name, and transferred by a clearinghouse.

In Notice 2018-08, the Treasury Department and the I.R.S. acknowledged the problem and announced the suspension of withholding under the new section for transfers of publicly traded partnership interests until further guidance is provided. Future guidance under the new law with respect to a disposition of an interest in a publicly traded partnership will be prospective and will include transition rules to allow sufficient time to prepare systems and processes for compliance.

I.R.S. APPEALS CHAMBER OF COMMERCE

In October of 2017, the U.S. District Court for the Western District of Texas struck down a provision under temporary anti-inversion regulations for violating the required notice and comment period under the Administrative Procedures Act (“A.P.A.”)⁴ on the grounds that the rule was a substantive or legislative rule and not an interpretive regulation.⁵

The court also held that the plaintiffs, (i) the U.S. Chamber of Commerce and (ii) the Texas Association of Business, had standing to bring the suit, as they suffered actual and concrete injury and that the plaintiffs could sue on behalf of members who would otherwise have standing in their own right. In addition, the court held that the plaintiffs’ action was not barred by the Anti-Injunction Act pursuant to Code §7874, as the suit did not restrain the assessment nor collection of any tax.

In favor of the government, the court held that the Agency did not engage in arbitrary and capricious rulemaking in issuing the rule and that it did not exceed its statutory jurisdiction.

As expected, the government filed a notice of appeal to the Fifth Circuit on November 27, 2017.



⁴ *Chamber of Commerce of the United States of America and Texas Association of Business v. I.R.S.*, (No. 74) (2017), amended October 6, 2017.

⁵ “Texas District Court on Anti-Inversion Legislation – One Down But Not Out,” *Insights* 11 (2017).

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.

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