



# INSIGHTS

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**HIGH-SPEED TAX REFORM: THE U.K. DIVERTED PROFITS TAX & RESTRICTIONS ON CORPORATE INTEREST DEDUCTIONS**

**QUALIFIED SMALL BUSINESS STOCK & THE EB-5 VISA PROGRAM – AN ATTRACTIVE COMBINATION FOR POTENTIAL INVESTORS**

**SALE OF A PARTNERSHIP INTEREST BY A FOREIGN PARTNER – IS REV. RUL. 91-32 BASED ON ACTUAL LAW OR ADMINISTRATIVE WISHES?**

**I.R.S. BREAKS THE SILENCE WITH REV. RUL. 2017-09, ISSUES GUIDANCE ON “NORTH-SOUTH” TRANSACTIONS**

**AND MORE**

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### About Us

## EDITORS' NOTE

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

- **High-Speed Tax Reform: The U.K. Diverted Profits Tax & Restrictions on Corporate Interest Deductions.** Among the most notable changes made to U.K. corporate tax over the past 24 months are the introduction of the diverted profits tax (“D.P.T.”) and the reduction of tax relief for corporate interest payments. D.P.T. is aimed at multinationals operating in the U.K. that try to avoid maintaining a permanent establishment in order to escape U.K. corporate tax. D.P.T. is imposed at the rate of 25% and treaty relief is not available. The reduction in relief for corporate interest payments implements the recommendations of B.E.P.S. Action 4. Eloise Walker and Penny Simmons of Pinsent Masons, London, explain the working of these provisions.
- **Qualified Small Business Stock & the EB-5 Visa Program – An Attractive Combination for Potential Investors.** Ever heard of qualified small business stock (“Q.S.B.S.”) as a means of investing in start-up companies? Although it is not typically thought of as a tax planning tool for foreign investors, when the foreign person is an applicant for an EB-5 visa, the tax results can be surprisingly good. Fanny Karaman and Beate Erwin explain.
- **Sale of a Partnership Interest by a Foreign Partner – Is Rev. Rul. 91-32 Based on Law or Administrative Wishes?** The I.R.S. has a long history in misapplying U.S. tax rules applicable to a sale of a partnership interest. For U.S. tax purposes, a partnership interest is treated as an asset separate and apart from an indirect interest in partnership assets. In Rev. Rul. 91-32, the I.R.S. misinterpreted case law and Code provisions to conclude that gains derived by foreign investors in U.S. partnerships are subject to tax. No one thought the I.R.S. position was correct, but then, in a field advice to an agent setting up an adjustment, the I.R.S. publicly stated that the ruling was a proper application of U.S. law when issued and remains so today. The adjustment was challenged in the Tax Court, and the tax bar is eagerly awaiting a decision. Stanley C. Ruchelman and Beate Erwin examine the I.R.S. position, the string of losses encountered by the I.R.S. when challenged by taxpayers, and the *Grecian Magnesite* case awaiting decision.
- **I.R.S. Pushes to Ease Implementation of Country-by-Country Reporting for U.S. M.N.E.'s.** It is widely known that the U.S. is following its own path towards international tax compliance. It has not signed onto the O.E.C.D.'s Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports; it does not participate in the Common Reporting Standard; and it did not sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent B.E.P.S. Nonetheless, at the request of U.S. multinationals, the I.R.S. has adopted domestic income tax regulations on country-by-country (“CbC”) reporting. In May, the I.R.S. confirmed the first bilateral competent authority agreement regarding CbC reporting was signed with the Netherlands. That agreement has now been followed by agreements with Canada, Denmark, Guernsey, Iceland, Ireland, Korea, Latvia, New Zealand, Norway, Slovakia, and South Africa. Galia Antebi and Kenneth Lobo delve into the U.S. rules and forms for CbC reports.

- **New Proposal for Swiss Corporate Tax Reform.** Through the first ten days of February, Swiss tax advisers were contemplating life after the adoption of the Corporate Tax Reform III (“C.T.R. III”). Then, the bottom dropped out from under their feet as Swiss voters defeated the tax reform package by an almost 60-40 majority. Now, a Steering Committee representing the cantons and Swiss Federation has issued T.P. 17, recommending a modified version of corporate tax reform. Peter von Burg and Dr. Natalie Peter of Staiger Attorneys, Zurich, compare the provisions in T.P. 17 with those in C.T.R. III.
- **I.R.S. Breaks the Silence with Rev. Rul. 2017-09, Issues Guidance on “North-South” Transactions.** In Rev. Rul. 2017-09, the I.R.S. addressed “north-south” transactions. In these transactions, a shareholder transfers property to a corporation in a transaction structured to be free of tax under Code §351. At about the same time, the corporation distributes shares of its subsidiary to the shareholder in a spinoff. If the transactions are considered separate for income tax purposes, each can be effected free of gain recognition and the imposition of income tax. On the other hand, if the transactions are integrated into a single multi-step transaction, gain will be recognized and tax imposed on each step of the arrangement. The ruling announces that the I.R.S. will once again rule on the status of these transactions and provides guidance on the standard that the I.R.S. will apply. Rusudan Shervashidze and Nina Krauthamer explain the factual context and the approach of the I.R.S. in granting relief.
- **Updates and Tidbits.** This month, Beate Erwin, Astrid Champion, and Nina Krauthamer look briefly at several timely issues, including (i) the return of foreign certified acceptance agents to the passport certification process in connection with the issuance of U.S. I.T.I.N.’s, (ii) the effect of the French election on French tax reform proposals, and (iii) demands for the U.S. to provide the same type of information as is supplied to I.G.A. partner countries.

We hope you enjoy this issue.

- The Editors

# HIGH-SPEED TAX REFORM: THE U.K. DIVERTED PROFITS TAX & RESTRICTIONS ON CORPORATE INTEREST DEDUCTIONS

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## Tags

Diverted Profits Tax  
Interest Deductions  
U.K.  
Tax Avoidance

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## INTRODUCTION

Over the past 24 months, the U.K. has seen significant changes to its corporate tax system. Two of the most notable changes concern the introduction of the new diverted profits tax (“D.P.T.”) and restrictions to the U.K.’s previously generous tax relief for corporate interest payments.

The speed at which the U.K. has introduced these wide-sweeping changes is unprecedented – D.P.T. was first announced in November 2014 and came into force on April 1, 2015 – and is driven by the U.K. government’s desire to combat unacceptable tax avoidance. This desire has been influenced by political pressure within the U.K. and from the international community.

The international focus on preventing corporate tax avoidance has been seen most notably through the O.E.C.D.’s Base Erosion and Profit Shifting Project (the “B.E.P.S. Project”). The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis.

Following international recognition that the global tax system requires a complete overhaul in order to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an action plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments.

This article briefly considers both D.P.T. and the new restrictions on U.K. tax relief for corporate interest payments.

## DIVERTED PROFITS TAX

D.P.T. is a U.K. tax aimed at multinationals operating in the U.K. that artificially syphon profits out of the U.K. or try to avoid maintaining a taxable establishment by playing the complexities of the global tax system. It is primarily an anti-avoidance measure and was introduced in the Finance Act 2015.

It will be of particular interest to non-U.K. taxpayers because the usual double tax treaty relief provisions, which one would expect to override D.P.T. and take taxpayers outside the charge, do not apply. The U.K.’s revenue service, HM Revenue & Customs (“H.M.R.C.”), takes the view that since D.P.T. is not income tax or corporation tax, it does not fall within the ambit of any of the U.K.’s current treaties. Some U.K. advisers to multinational groups expect that as individual treaties are updated, treaty partner jurisdictions will insist that the U.K. extend treaty protection

to D.P.T. Others are more skeptical, believing that the B.E.P.S. Project changed the expectations regarding the purpose of an income tax treaty. Preventing double non-taxation is now as important as preventing double taxation. In any event, treaty renegotiation is a process that will take years to come to fruition. Consequently, the intention of H.M.R.C. is that multinationals that do not have a U.K. permanent establishment (“P.E.”) under a treaty are subject to U.K. tax as a measure to prevent unacceptable tax planning.

The current rate of D.P.T. is 25% of the diverted profit. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Given that the rate of U.K. corporation tax is currently 19% (and set to be reduced further to 17% from April 1, 2020), it is expected that companies affected by D.P.T. will seek to restructure operations so as to derive profits in the U.K.

### **When Does D.P.T. Apply?**

D.P.T. applies to diverted profits arising on or after April 1, 2015. Apportionment rules are provided for accounting periods that straddle that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or P.E. and there are arrangements between connected parties that “lack economic substance” in order to exploit tax mismatches. (One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity that is located in a tax haven and lacks the capability to perform an actual function that justifies the payment.)
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a P.E. in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. (This is referred to as the “avoidance of a U.K. taxable presence.”)

Generally, in practice, D.P.T. should not apply to small- and medium-sized companies (“S.M.E.’s”). If a company has less than 250 employees and either its turnover is no more than €50 million or its assets are no more than €43 million, it should qualify as an S.M.E. However, when calculating whether a company is an S.M.E., it may be necessary to aggregate the number of employees and turnover/assets of certain linked companies.

### **Companies or P.E.’s Lacking Economic Substance**

Where companies or P.E.’s lack economic substance, there are two tests that must be considered:

- The insufficient economic substance condition
- The effective tax mismatch condition

If either test is met, a D.P.T. charge will be payable.

*“Where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise.”*

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction.

Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person's involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that perform a real function that justifies the financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party. There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, and payments to certain offshore funds or authorized investment funds.

### **Avoidance of a U.K. Taxable Presence**

Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporation tax charge.

Avoidance of a U.K. taxable presence does not exist if the U.K. activity is undertaken by someone acting as an agent of independent status or for the purposes of alternative finance arrangements.

There are also specific exceptions from a D.P.T. charge if, in a 12-month accounting period, U.K.-related sales are below £10 million or U.K.-related expenses are below £1 million.

### **Calculation of the D.P.T. Charge**

Calculating the D.P.T. charge is complex, and various rules must be considered. Broadly, it will be necessary to consider profits that would have arisen if the company had made a full transfer pricing adjustment. It will also be necessary to determine the amount of profit that would have arisen from an alternative transaction that would have reasonably taken place if a tax reduction had not been relevant to the parties.

H.M.R.C. has stated that no taxable diverted profits should arise if, in the relevant transactions, the company made transfer pricing adjustments that put it in the same tax position as if arm's length pricing had been used.

The main difficulty when calculating D.P.T. is likely to be the assumption that it is relatively easy to determine an appropriate alternative transaction that would have reasonably taken place if a tax reduction had not been relevant.

## **What Happens if D.P.T. Applies?**

### **Notification**

D.P.T. has its own specific rules for assessment and payment. D.P.T. is not self-assessed; rather, companies must notify H.M.R.C. if they are potentially within the scope of D.P.T. and do not satisfy any of the exemptions. Usually, this notification must be given within three months after the end of the company's accounting period.

### **Preliminary Notice**

Following notification, if H.M.R.C. believes that a company may be liable for D.P.T., it will issue a preliminary notice to the U.K. company or P.E. This notice must outline the grounds on which H.M.R.C. considers D.P.T. to be payable and calculate D.P.T. based on certain simplified assumptions. H.M.R.C. is also entitled to disallow up to 30% of the relevant tax-deductible expenses of the company, where it finds that these expenses are higher than they would have been if the transaction had been carried out on arm's length terms.

H.M.R.C. must issue a preliminary notice within two years of the end of the accounting period in which the D.P.T. charge arose. A company or P.E. has 30 days to contact H.M.R.C. to correct obvious errors in the notice, which might include arithmetical errors or errors regarding the company's status as an S.M.E. However, there is no right to appeal the preliminary notice.

The test for whether a D.P.T. charge applies relies heavily on questions of fact. Therefore, it is vital that taxpayers engage with H.M.R.C. in the period after making a notification of potential chargeability, during which H.M.R.C. will consider whether to issue a preliminary notice.

### **Charging Notice**

Within 30 days of receiving any representations, H.M.R.C. must either issue a charging notice stating the amount of D.P.T. payable by the U.K. company or P.E., or notify the recipient that no D.P.T. is payable. The recipient then has 30 days from receipt of the charging notice to pay any D.P.T. due. There is no right to appeal the preliminary notice or charging notice prior to payment, and there are no grounds for delaying payment.

### **Appeals**

Following payment, H.M.R.C. has 12 months to review the charge to D.P.T. During this time, the charge may be reduced or increased. The company or P.E. can appeal a D.P.T. charge only after the 12-month review period has ended. An appeal is heard by the Tax Tribunal. If no appeal is made, the D.P.T. charge becomes final.

The fact that there is no right of appeal until 12 months after payment of any D.P.T. charge will mean that companies that are ultimately successful on appeal will suffer a significant cash flow disadvantage.

### **Clearances**

There is no formal clearance procedure for D.P.T., although it may be possible to obtain a written opinion from H.M.R.C. on the likelihood a D.P.T. notice will be issued.



However, H.M.R.C. has cautioned that it will not be able to provide a view on whether transactions are likely to fall within the scope of D.P.T. in every case where an opinion is sought.

### **Expected Impact of D.P.T.**

Although originally flagged to the market as a pure anti-avoidance measure that would be used only in exceptional cases of egregious tax planning, D.P.T. is expected to have a significant impact on multinationals and how they structure their businesses. In September 2016, H.M.R.C. announced that it had identified almost 100 multinationals as being potentially within the scope of the new tax and was expecting many of them to dispute the charge.

Indeed, in November 2016, H.M.R.C. released figures showing that the amount of U.K. tax potentially underpaid by big businesses due to shifting profits to other jurisdictions has increased by 60% in the last year, to £3.8 billion.

This substantial increase suggests that H.M.R.C. has opened a significant number of new inquiries over the last 24 months, focusing on intra-group, cross-border transactions. It has been suggested that D.P.T. could be one of the factors driving the increased amount of tax under consideration by H.M.R.C., and it is certainly the case that a threat of a D.P.T. charge is being used by H.M.R.C. as a weapon in transfer pricing disputes to force taxpayers to re-allocate taxable profit to the U.K.

It is clear that the scope of D.P.T. is wide and that extensive resources are being given to H.M.R.C. to assess D.P.T. issues. Multinationals operating in the U.K. should expect H.M.R.C. to explore in depth whether a D.P.T. charging notice should be issued. Since the conditions for D.P.T. rely heavily on questions of fact, it is vital that companies engage in full fact finding and present evidence to H.M.R.C. in as cogent a way as possible to support their arguments. It is also essential that companies have proper transfer pricing benchmarking measures both in place and appropriately evidenced, since this is a key way of avoiding a D.P.T. charge.

## **RESTRICTIONS TO CORPORATE INTEREST EXPENSE DEDUCTIONS**

On April 1, 2017, the U.K. government introduced new rules restricting tax deductions for corporate interest payments. The draft legislation for inclusion in Finance Bill 2017 was published in full on March 20, 2017. However, following the U.K. prime minister's decision to hold a general election on June 8, 2017, the draft provisions for the new rules were removed from the Finance Act 2017, which received royal assent (thereby becoming law) on April 27, 2017.

At the time of writing, it is uncertain whether the draft legislation will be enacted in a second finance bill this year and will still have effect from April 1, 2017. Depending on the outcome of the general election, it is possible that the draft legislation could be included as part of a second Finance Bill in summer 2017, or its enactment could be deferred further. Although such things are never certain, irrespective of the outcome of the general election, it is probable that the legislation will eventually be enacted in something like its current form, since it is rare for a measure so far advanced (and so lucrative for the U.K.'s Treasury) to be abandoned.



*“Under the new U.K. rules, tax relief for interest and certain other financing costs will be limited to 30% of tax-E.B.I.T.D.A.”*

## **Previous U.K. Interest Deductibility Rules**

Prior to April 1, 2017, the U.K. had generous rules in relation to tax relief on corporate interest payments. Generally, interest paid on debt financing was deductible from a company's U.K. corporation tax profits and therefore a company's liability to U.K. corporation tax was reduced.

In theory, interest payments could be used to reduce U.K. corporation tax payments. This form of tax relief was often invaluable, particularly to those corporations operating in the energy, real estate, and infrastructure sectors, which are heavily reliant on debt financing when embarking on new projects.

A range of anti-avoidance provisions existed to restrict excessive interest deductions, although there was no general limitation rule. Nevertheless, there was concern that the U.K.'s generous rules were open to abuse. For example, it was often cited that the U.K. interest deductibility rules enabled multinationals to load up U.K. companies with high levels of debt to reduce taxable profits, whilst shifting business profits to lower-tax jurisdictions that are tax havens.

However, given that the U.K. has extensive anti-avoidance rules to prevent such abuse, these concerns did not really carry any weight until the advent of the B.E.P.S. Project, which was the main driver for change.

## **Background to the New Rules – the B.E.P.S. Project**

In July 2013, when the O.E.C.D. published its plan proposing 15 actions designed to combat B.E.P.S., Action 4 focused on limiting B.E.P.S. via interest deductions and, specifically, whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

In October 2015, the O.E.C.D. published its final recommendations in relation to Action 4. It recommended the introduction of a general interest limitation rule that should operate by restricting interest deductions by reference to a fixed ratio of a company's earnings before interest, taxes, depreciation, and amortization (“E.B.I.T.D.A.”). The O.E.C.D. did not specify the level of this ratio; rather, it advocated that countries should choose an E.B.I.T.D.A. ratio of between 10% and 30%.

The O.E.C.D. recommended that there should be an optional exclusion for interest on loans used to fund public benefit projects. The rationale for this is that certain public benefit projects are considered to have a low tax avoidance risk.

The O.E.C.D. also recommended introducing several safeguards to address any potential volatility that the rule may create. These included a *de minimis* threshold for low risk entities and carry forward provisions, whereby disallowed interest deductions can be carried forward and deducted in a future accounting period.

The O.E.C.D. also suggested that jurisdictions should consider introducing suitable transitional rules, particularly to enable existing third-party debt to be excluded or “grandfathered” from the ambit of the new restrictions.

## **Overview of the New U.K. Rules**

Under the new U.K. rules, tax relief for interest and certain other financing costs will be limited to 30% of tax-E.B.I.T.D.A., which will broadly be profits chargeable to

corporation tax, excluding interest, increased by (i) tax depreciation such as capital allowances, (ii) tax amortization and relief for losses brought forward or carried back, and (iii) group relief claimed or surrendered.

When applying the rule, groups will generally need to work out the tax-E.B.I.T.D.A. of each U.K.-resident member company and each U.K. P.E., and add them together. The limit on deductible interest will be 30% of that figure.

There will be a *de minimis* allowance of £2 million per annum, which means that groups with a net interest expense below this threshold will be unaffected by the fixed ratio rule.

A company will be able to carry-forward *indefinitely* interest expenses that have been restricted under the rule. The interest carried forward may then be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period it will be able to carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after five years.

The new restrictions will apply to interest on existing loans as well as new loans, although limited grandfathering will be available in certain circumstances (see below).

### **Group Ratio Rule**

The new rules will include a group ratio rule (“G.R.R.”), based on the net interest to group E.B.I.T.D.A. ratio for the worldwide group, and will allow deductions up to the net interest to group E.B.I.T.D.A. ratio for the worldwide group if this exceeds the fixed ratio. This is intended to help groups with high external gearing for genuine commercial purposes, by substituting the G.R.R. for the fixed ratio rule if it produces a better result for the group.

The G.R.R. will be calculated by dividing the net *qualifying* group interest expense by the group E.B.I.T.D.A. When calculating the G.R.R., whilst net interest is essentially calculated in the same way as for the fixed ratio rule, the worldwide group-E.B.I.T.D.A. is an accounting measure – it broadly equals the consolidated profit before tax of the worldwide group, adjusted for depreciation and net interest.

The G.R.R. will be used as an alternative to the 30% fixed ratio rule. The amount of deductions available under the G.R.R. will be capped at 100% of tax-E.B.I.T.D.A.

Interest on related-party loans, perpetual loans, and result-dependent loans will not be included in the calculation of the G.R.R.

Earlier drafts of the legislation provided that a third-party loan guaranteed by a related party would constitute related-party debt, which would have resulted in many commercial loans being ineligible to be used as part of the G.R.R. However, following extensive lobbying from industry, the draft legislation has been revised and now provides that a loan will not be treated as having been made by related parties where (i) a guarantee is provided by a member of the debtor’s group, (ii) financial assistance is only provided in relation to shares in the ultimate parent entity, or loans to a member of the group, or (iii) financial assistance is a non-financial guarantee. Limited grandfathering is also now available for guarantees provided prior to April 1, 2017.

## **Public Infrastructure Exemption**

To maintain investment in the U.K.'s infrastructure sector, there will be an exclusion for interest paid on public infrastructure projects, known as the Public Infrastructure Exemption ("P.I.E."). Infrastructure projects tend to be highly geared, and their viability is often dependent on the availability of debt financing. Without a specific exclusion, many infrastructure projects would not get off the ground due to lack of affordable debt financing and difficulty raising equity finance.

The P.I.E. will only be available if an election is made and will only apply to companies where all, or significantly all, their income and assets relate to activities involving public infrastructure assets.

### **Meaning of Public Infrastructure Assets**

For this purpose, public infrastructure assets will include the following assets:

- Tangible U.K. infrastructure assets that meet a "public benefit test"
- Buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties

The public infrastructure asset must also have, or be likely to have, an expected economic life of at least ten years and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset will meet the public benefit test if it is procured by a relevant public body (such as a government department, local authority, or health service body) or will be used in the course of an activity that is or could be regulated by an "infrastructure authority." This second leg of the definition should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset. The exemption will also apply to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a "qualifying infrastructure asset" if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. "Short-term basis" means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

### **Third-Party Debt Requirement**

The P.I.E. will only apply to interest paid to third parties where the recourse of the creditor is limited to the income, assets, shares, or debt issued by a qualifying infrastructure company, which need not be the borrower.

Guarantees from parent companies or non-infrastructure companies within the group could prevent the exemption from applying. However, guarantees provided before April 1, 2017, and certain non-financial guarantees (relating to providing the services) will now be ignored.



### Grandfathering Provisions

Originally, no grandfathering was proposed. However, there were significant concerns that grandfathering was required to prevent existing infrastructure projects from going into default, particularly those with shareholder debt, such as many existing P.F.I.-type projects, which may find it difficult to restructure. Examples include infrastructure projects involving U.K. schools and hospitals that are highly geared for genuine commercial reasons and where viability of a particular project is dependent on the tax deductibility of the project's interest expenses. These projects may have commenced ten years prior to enactment and may still have 20 or more years left to run – a restriction on tax relief could be catastrophic to the continued viability of such projects.

After much lobbying by industry, grandfathering was introduced for these projects. Although the new restrictions will apply to interest on existing loans, limited grandfathering will be available for infrastructure companies within the P.I.E. if the following conditions are satisfied:

- The loan relationships were entered into on or before May 12, 2016.
- At least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years were highly predictable by reference to certain public contracts.

A transitional provision also applies in the first year to enable groups to restructure to fall within the P.I.E.

### Administration of the New Rules

The new rules operate by assessing the level of interest in the worldwide group and therefore any restriction on the deductibility of interest cannot be processed through a company's normal U.K. corporation tax return. U.K. companies will now need to file a new interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies. If a company elects to complete the short-form interest restriction return, it will not be able to use its interest allowance in a later period, although it will have 60 months to revoke its election and submit a full return.

Groups must appoint a reporting company to make the return. This is a company that is not dormant and was a U.K. group company or a group member subject to U.K. corporation tax for at least part of the relevant period to which the return relates.

### Expected Impact of the New Interest Restriction

The exact impact of the new restrictions is not yet certain since the draft legislation, although far advanced, did not reach its final form at the time of the Finance Act 2017. However, multinationals can expect to undergo an extensive year-by-year compliance procedure to determine how much of the current U.K. interest deductions will become disallowable retroactively. A period of uncertainty will likely exist

during which corporate restructuring of U.K. sub-group debt-to-equity ratios may take place as if the new rules will be applicable.

## SUMMARY

Both D.P.T. and the new restrictions on corporate interest deductions could have a significant impact on the structuring of U.K. corporate transactions involving significant levels of debt financing and entities located in multiple jurisdictions. Although both measures are predominately aimed at preventing aggressive forms of tax avoidance, they will unwittingly affect genuine commercial transactions. As with much U.K. tax legislation, both sets of rules are very complicated and can be difficult to navigate. Therefore, U.K. tax advice should always be sought before trying to apply the rules.

*“Multinationals can expect to undergo an extensive year-by-year compliance procedure.”*

# QUALIFIED SMALL BUSINESS STOCK & THE EB-5 VISA PROGRAM – AN ATTRACTIVE COMBINATION FOR POTENTIAL INVESTORS

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## Tags

Angel Investing  
Start-Up  
Q.S.B.S.

In today's start-up world, angel investing<sup>1</sup> is a typical part of an entrepreneur's routine. Angel investors generally provide start-ups or entrepreneurs with seed capital, which can be structured in many ways, including pure equity investments with or without voting rights, convertible notes, and stock options. Not often mentioned, however, are investment models that are fashioned to be equity investments in "small business corporations." This article explains how gain realized on the sale of qualified small business stock ("Q.S.B.S.") is completely free of Federal income taxes for U.S. tax residents, including those holding green cards. This preferential but little-known tax break became permanent with the passage of the Protecting Americans from Tax Hikes ("P.A.T.H.") Act on December 18, 2015.<sup>2</sup>

Q.S.B.S. is an interesting investment tool. Although (i) the regime is limited to stock in U.S. C-corporations and (ii) individuals living outside the U.S. are generally not subject to capital gains realized on the sale of stock in a U.S. corporation, it provides benefits for non-U.S. investors who plan to move to the U.S., particularly those who enter under the EB-5 visa program of the U.S. Citizenship and Immigration Services ("U.S.C.I.S.") of the Department of Homeland Security. It also offers incentives for U.S. investors to invest in U.S. start-ups, as opposed to non-U.S. start-ups. Most importantly, it constitutes an additional incentive start-up founders can use to attract funding.

Under the Q.S.B.S. regime, a U.S. resident investing in Q.S.B.S. could be totally exempt from U.S. capital gains tax upon sale.<sup>3</sup> Further, if that individual is a N.Y. resident, the capital gain would also benefit from an exemption at the state and local levels. Finally, the excludable gain does not carry adverse alternative minimum tax consequences and is not subject to net investment income tax.

## DEFINITION OF Q.S.B.S.

The Q.S.B.S. regime is limited to stock meeting the following cumulative requirements:<sup>4</sup>

- The stock constitutes stock of a C-corporation issued after August 10, 1993.
- The issuing corporation is a qualified small business as of the date of the issuance (the "Q.S.B. Test").

<sup>1</sup> See Simon Prisk, "Corporate Matters: Angel Investing, an Introduction," *Insights* 4 (2014).

<sup>2</sup> Code §1202(a)(4) as amended by 2015 P.A.T.H. Act §126(a)(1), DivQ, P.L. 114-113.

<sup>3</sup> Corporate investors are excluded from this provision (Code §1202(a)(1)).

<sup>4</sup> Code §1202(c)(1).

- The stock is generally acquired by the taxpayer at its original issue in exchange for money or other property, or as compensation for services (the “Original Issuance Test”).
- During substantially all of the shareholder’s holding period of such stock, the issuing corporation meets an active business requirement (the “Active Business Test”).

### **The Q.S.B. Test**

The following cumulative requirements must be met for purposes of the Q.S.B. test:

- The issuing entity is a U.S. C-corporation.<sup>5</sup>
- The aggregate gross assets of the corporation (or a predecessor) do not exceed \$50,000,000 from August 10, 1993, until immediately after the issuance of the stock for which preferential treatment is sought.<sup>6</sup>
- The issuing corporation submits reports to its shareholders and the I.R.S. as the I.R.S. may require.<sup>7</sup>

For the purpose of the gross asset requirement, cash and the adjusted bases of property held by the corporation constitute “aggregate gross assets.”<sup>8</sup> As a result, the post-issuance growth of a start-up does not disqualify such corporation from meeting the Q.S.B. test.

All corporations that are part of the same parent-subsidary controlled group will be treated as one person.<sup>9</sup> A parent-subsidary controlled group is constituted by one or more chains of corporations connected through ownership with a common parent.<sup>10</sup> A 50% ownership test (by vote or value) must be met for the corporations to be part of said controlled group.

### **The Original Issuance Test**

As mentioned earlier, this test is generally met if the stock is acquired by the taxpayer at its original issue in exchange for money or other property (other than stock) or as compensation for services.<sup>11</sup>

In order to ensure that only new investments in start-ups give rise to the beneficial tax regime, the following pre-issuance or post-issuance redemption transactions disqualify the stock from the beneficial regime:

<sup>5</sup> Code §1202(d)(1).

<sup>6</sup> Code §§1202(d)(1)(A), (B).

<sup>7</sup> Code §1202(d)(1)(C). The I.R.S. did not publish any guidance yet as to such reports.

<sup>8</sup> Code §1202(d)(2). For assets contributed to the corporation, the basis is the fair market value of the contributed assets immediately after the contribution.

<sup>9</sup> Code §1202(d)(3)(A).

<sup>10</sup> Code §1202(d)(3)(B). Direct ownership and constructive ownership rules under Code §§1563(e)(1), (2), and (3) apply.

<sup>11</sup> Code §1202(c)(1)(B). Stock acquired as compensation for services excludes stock acquired for services performed as an underwriter of the stock (Code §1202(c)(1)(B)(i)).



- Redemptions from the shareholder, or a person related to the shareholder, during the period starting two years prior to the issuance of the stock and ending two years after the issuance of the stock<sup>12</sup>
- One or more significant redemptions made during the period starting one year prior to the issuance of the stock and ending one year after the issuance of the stock<sup>13</sup>

For this purpose, a “significant redemption” is one or more purchases by a corporation of its stock, wherein the aggregate value exceeds 5% of the aggregate value of all of the stock of the corporation as of the beginning of the aforementioned two-year period. In addition, the purchased stock must be in excess of \$10,000 and constitute more than 2% of all outstanding stock.<sup>14</sup>

Certain tax-free transfers, such as (but not limited to) gifts or inheritances,<sup>15</sup> certain transfers from partnerships to partners,<sup>16</sup> certain stock conversions,<sup>17</sup> and certain reorganizations and incorporations<sup>18</sup> do not disqualify the stock from meeting the Original Issuance Test.

### **The Active Business Test**

This test must be met during substantially all of the taxpayer’s holding period for such stock.<sup>19</sup> Further, the following cumulative requirements must be met:<sup>20</sup>

- The corporation must actively conduct one or more qualified trades or businesses.<sup>21</sup>
- At least 80%, by value, of the assets of the corporation are used by such corporation in the active conduct of such qualified trades or businesses.<sup>22</sup>

<sup>12</sup> Code §1202(c)(3)(A). A *de minimis* exception exists for redemptions not meeting the following requirements: (i) The aggregate amount paid for the stock exceeds \$10,000, and (ii) more than 2% of the stock held by the taxpayer and related persons is acquired (Treas. Reg. §1.1202-2(a)). For this purpose, any stock purchase by a corporation related to the issuer that is treated as a redemption pursuant to Code §304 is treated as a purchase by the issuing corporation in an amount equal to the amount treated as a redemption distribution (Code §1202(c)(3)(C)).

<sup>13</sup> Code §1202.

<sup>14</sup> Treas. Reg. §1.1202-2(b). Any stock purchase by corporations related to the issuer and treated as a redemption pursuant to Code §304 is treated as a purchase by the issuing corporation in an amount equal to the amount treated as a redemption distribution (Code §1202(c)(3)(C)).

<sup>15</sup> Code §§1202(h)(2)(A), (B).

<sup>16</sup> Code §1202(h)(2)(C).

<sup>17</sup> Code §1202(f).

<sup>18</sup> Code §1202(h)(4).

<sup>19</sup> Code §1202(c)(2)(A).

<sup>20</sup> Code §1202(e). A waiver exists for specialized small investment companies (Code §1202(c)(2)(B)(i)).

<sup>21</sup> Code §1202(e)(1)(A).

<sup>22</sup> *Id.*



*“While the [Active Business] test is comprehensive . . . most early-stage investments in C-corporation technology companies should, for example, meet these requirements.”*

For this purpose, stock and debt in subsidiaries<sup>23</sup> are disregarded and the parent is considered to own its ratable share of the subsidiary’s assets and to conduct its ratable share of the subsidiary’s activities.<sup>24</sup> Certain assets that are (i) used for research or start-up activities<sup>25</sup> and (ii) are held as working capital<sup>26</sup> or constitute rights to computer software<sup>27</sup> may automatically be treated as used in the active conduct of a qualified trade or business. Other assets held excessively, such as real estate or portfolio securities, automatically disqualify the corporation from meeting the Active Business Test.<sup>28</sup>

- The corporation is an eligible corporation.

A qualified trade or business is any business with the exception of the following:<sup>29</sup>

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees
- Any banking, insurance, financing, leasing, investing, or similar business
- Any farming business (including the business of raising or harvesting trees)
- Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Code §§613 or 613(a)
- Any business of operating a hotel, motel, restaurant, or similar business

The corporation is an eligible corporation if it is any U.S. C-corporation other than the following:<sup>30</sup>

- A domestic international sales corporation (“D.I.S.C.”) or former D.I.S.C.
- A corporation with respect to which an election under Code §936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect
- A regulated investment company, real estate investment trust, or real estate mortgage investment conduit (“R.E.M.I.C.”)
- A cooperative

While the test is comprehensive, requiring a detailed review that is beyond the scope

<sup>23</sup> For this purpose, a corporation is considered a subsidiary if the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock of such corporation.

<sup>24</sup> Code §1202(e)(5)(A).

<sup>25</sup> Code §1202(e)(2).

<sup>26</sup> Code §1202(e)(6).

<sup>27</sup> Code §1202(e)(8).

<sup>28</sup> Code §§1202(e)(5)(B), (7).

<sup>29</sup> Code §1202(e)(3).

<sup>30</sup> Code §1202(e)(4).

of this article, most early-stage investments in C-corporation technology companies should, for example, meet these requirements.

## EXCLUSION OF GAIN FROM INCOME

If the stock qualifies as Q.S.B.S., an individual shareholder may claim an exemption on part or all of the gain realized upon a sale of the stock<sup>31</sup> – subject to a holding period requirement,<sup>32</sup> an acquisition date-based limitation,<sup>33</sup> and a per-issuer cap.<sup>34</sup>

First, in order to be able to claim the exclusion, the taxpayer must hold the Q.S.B.S. for more than five years.<sup>35</sup> A deferral of capital gains tax may be available when the taxpayer does not respect the five-year holding period, has held the stock for six months, and uses the sales proceeds to purchase Q.S.B.S. within 60 days of the sale.<sup>36</sup>

Second, the extent of the available exclusion varies depending on the acquisition date of the Q.S.B.S. stock. The following acquisition dates give rise to income exclusions:

- Capital gain realized on the sale of Q.S.B.S. acquired on or before February 17, 2009, can benefit from a 50% exclusion.<sup>37</sup>
- Capital gain realized on the sale of Q.S.B.S. acquired after February 17, 2009, and before September 28, 2010, can benefit from a 75% exclusion.<sup>38</sup>
- Capital gain realized on the sale of Q.S.B.S. acquired after September 27, 2010, can benefit from a total exclusion.<sup>39</sup>

Lastly, the above exclusions are capped on a per-issuer basis.<sup>40</sup> The eligible excluded gain cannot exceed the greater of

- \$10,000,000, reduced by the aggregate amount of eligible gain for prior taxable years and attributable to dispositions of stock issued by the same corporation,<sup>41</sup> or
- 10 times the aggregate adjusted bases of the Q.S.B.S. issued by the corporation and disposed of by the taxpayer during the taxable year.<sup>42</sup>

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<sup>31</sup> Code §1202(a).

<sup>32</sup> Code §1202(b)(2).

<sup>33</sup> Code §1202(a).

<sup>34</sup> Code §1202(b).

<sup>35</sup> Code §1202(b)(2).

<sup>36</sup> Code §1045.

<sup>37</sup> Code §1202(a)(1).

<sup>38</sup> Code §1202(a)(3).

<sup>39</sup> Code §1202(a)(4).

<sup>40</sup> Code §1202(b).

<sup>41</sup> Code §1202(b)(1)(A).

<sup>42</sup> Code §1202(b)(1)(B). As a result, if the taxpayer does not qualify for the 100% exclusion, but only for the 75% exclusion for instance, only 75% of the above

Finally, for Q.S.B.S. acquired after September 27, 2010, the excluded gain no longer carries an alternative minimum tax exposure.<sup>43</sup> Notably, the 3.8% net investment income tax does not apply to the amount of the exclusion.<sup>44</sup> While some states, such as New York, follow the Federal exclusion regime,<sup>45</sup> others may not. Hence, state and local law should be checked prior to making an investment decision for purposes of benefitting from the Q.S.B.S. rules.

From a compliance perspective, an individual investor should be aware of the obligation to file Form 8949, *Sales and Other Dispositions of Capital Assets*, for the year in which the gain is realized.

## THE EB-5 VISA PROGRAM

The U.S.C.I.S. administers the EB-5 program, which was created to stimulate the U.S. economy through job creation and capital investment by foreign investors. In broad terms, all EB-5 investors must invest in a new commercial enterprise,<sup>46</sup> which means any for-profit activity formed for the ongoing conduct of lawful business by any one of several types of entities, including a corporation.<sup>47</sup> This definition includes a holding company and its wholly owned subsidiaries, provided that each such subsidiary is engaged in a for-profit activity and is formed for the ongoing conduct of a lawful business.<sup>48</sup>

An EB-5 investor must generally invest the required amount of capital in a new commercial enterprise that will create full-time positions for at least 10 qualifying employees.<sup>49</sup> For a new commercial enterprise not located within a regional center, the full-time positions must be created directly by the new commercial enterprise. This means that the new commercial enterprise (or its wholly owned subsidiaries) must itself be the employer of the qualifying employees. For a new commercial enterprise located within a regional center, the full-time positions can be created either directly or indirectly by the new commercial enterprise.

Direct jobs are those jobs that establish an employer-employee relationship between the new commercial enterprise and the persons it employs.<sup>50</sup> Indirect jobs are those jobs held outside of the new commercial enterprise but that are created as a result of the new commercial enterprise.<sup>51</sup>

Capital means cash, equipment, inventory, other tangible property, cash equivalents, and indebtedness secured by assets owned by the alien entrepreneur, provided that

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limits (*i.e.*, \$7,500,000 and 7.5 time the aggregate adjusted bases) apply.

<sup>43</sup> Code §1202(4)(C).

<sup>44</sup> Code §1411(c)(1)(A)(iii).

<sup>45</sup> N.Y. Tax Law §612.

<sup>46</sup> 8 C.F.R. 204.6(e): a new commercial enterprise is any commercial enterprise established after November 29, 1990.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at *Commercial Enterprise*.

<sup>49</sup> 8 C.F.R. 204.6(j).

<sup>50</sup> 8 C.F.R. 204.6(e), *Employee*.

<sup>51</sup> *Id.*

***“For Q.S.B.S. acquired after September 27, 2010, the excluded gain no longer carries an alternative minimum tax exposure.”***

the alien entrepreneur is personally and primarily liable and that the assets of the new commercial enterprise upon which the petition is based are not used to secure any of the indebtedness. All capital is valued at fair-market value denominated in U.S. dollars.<sup>52</sup>

If the terms of the EB-5 program are met, the investor is granted a temporary green card, which may become permanent after two years if all requirements regarding job creation and investment levels are met. This means that from the time the visa is issued, the holder is subject to U.S. Federal income tax on worldwide income. If the investment is made in Q.S.B.S., tax on gains derived from the sale of shares that meet the requirements of the Q.S.B.S. provisions can be eliminated within the limitations of U.S. tax law.

## CONCLUSION

The combination of Q.S.B.S. tax regime and the EB-5 program for foreign investors provide foreign persons interested in obtaining green cards with a trifecta of benefits. invest in the U.S.:

- They provide foreign investors with the opportunity to obtain permanent residence in the U.S. if all EB-5 requirements are met.
- They grant green card holders the opportunity of obtaining tax-free gain if their investment meets the Q.S.B.S. requirements.
- They avoid the costs and problems that are frequently encountered when investments are made through packagers of EB-5 programs.

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8 C.F.R. 204.6(e), *Capital*.

# SALE OF AN INTEREST BY A FOREIGN PARTNER – IS REV. RUL. 91-32 BASED ON LAW OR ADMINISTRATIVE WISHES?

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## Tags

Code §741  
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Code §897  
Code §1445  
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F.I.R.P.T.A.  
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Sale

## INTRODUCTION

In Rev. Rul. 91-32, the I.R.S. announced its view that foreign partners in partnerships operating in the U.S. (including foreign members of L.L.C.'s) are properly taxed on their capital gains under a look-thru rule to the assets owned by the partnership. Without much justification other than an acknowledgement that any other approach would prevent the I.R.S. from collecting tax, the I.R.S. claims that the rules for taxing partners on gains from the disposal of an interest in a partnership simply are different when the partner is not a U.S. person – a doubtful proposition in light of specific provisions of the Internal Revenue Code and case law. This article addresses the U.S. tax rules for determining when gain derived by a non-U.S. person is taxed in the U.S., the facts in Rev. Rul. 91-32, and a Tax Court case awaiting decision in which the validity of Rev. Rul. 91-32 is squarely in issue.

## BACKGROUND

In general, U.S. tax law provides that an interest in a partnership is treated as a capital asset, and a sale of a partnership interest is treated as the sale of that asset. This is commonly referred to as the “entity theory” of partnerships.<sup>1</sup>

Notwithstanding such entity treatment for a partnership interest, when income, gain, loss, or credit is recognized by a partnership, its partners are treated as if they received their distributive shares of such income, gain, loss, or credit directly from the source.<sup>2</sup> This is commonly referred to as the “aggregate theory” of partnerships, meaning that a partnership is nothing more than a contractual arrangement among the partners.

If the aggregate treatment applied when a partner disposed of a share of a partnership interest, a sale of that interest would in effect be treated as a sale of an undivided interest in each asset owned by the partnership, including inventory, investments, cash, and fixed assets. To the extent sales proceeds related to inventory, income would be recognized presumably based on the difference between the portion of the sales price allocated to the inventory and the carrying value of the inventory. Ordinary income would be produced for the seller of the partnership interest. Similarly, to the extent sales proceeds related to fixed assets, the difference between the portion of the sales price allocated to each fixed asset and the adjusted basis of that asset would produce capital gain, under Code §1231, except for the depreciation recapture.

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<sup>1</sup> Code §741.

<sup>2</sup> Code §702(b).

In order to achieve roughly comparable results in the division between capital gains subject to favorable tax rates for individuals and ordinary income taxed at regular tax rates of up to 39.6% at the Federal level, U.S. tax law either expressly adopts the aggregate approach, which is limited to F.I.R.P.T.A. treatment of foreign investors in real estate partnerships and Subpart F inclusions when a C.F.C. sells a partnership interest,<sup>3</sup> or treats the gain as if it produced ordinary income, which is accomplished by honoring the entity theory but increasing the rates of tax for some or all of the gain.<sup>4</sup>

Rev. Rul. 91-32 involves a foreign investor in a partnership that engages in a U.S. business but does not invest in real estate. In that fact pattern, the carefully devised tests that are applied to distinguish between effectively connected capital gains that are taxable and capital gains that are not taxable lead to only one conclusion – under the law as written, the gain is a capital gain, and in most circumstances, that gain is free of tax for a non-U.S. partner.

## TEST FOR DETERMINING EFFECTIVELY CONNECTED GAINS

### U.S.-Source Income

The general source of income rule is set forth in Code §865(a), which provides that income from the sale of personal property by a non-U.S. person is treated as foreign-source income unless provided otherwise in Code §865.

A special source rule in Code §865(e) applies if (i) the foreign person maintains an office or other fixed place of business in the U.S., and (ii) the sale of personal property is “attributable” to the U.S. office or other fixed place of business.<sup>5</sup> Under Code §864(c)(5)(B), a taxpayer’s gain is not attributable to a U.S. office or other fixed place of business unless the office or fixed place of business is a “material factor” in the production of the gain and “regularly carries on activities of the type from which such gain . . . is derived.” If applicable, this special rule would make the income from the sale of personal property U.S. source.

### Effectively Connected Income

Relevant income tax regulations<sup>6</sup> issued by the I.R.S. provide that for the purposes of determining whether any income or gain from sources within the U.S. arising from the sale or exchange of capital assets is effectively connected income for the taxable year, the principal tests to be applied are (i) the “asset-use test” and (ii) the “business-activity test.” The asset-use test measures whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of a trade or business in the U.S. The business-activity test measures whether the activities of the trade or business conducted in the U.S. were a material factor in the realization of the income, gain, or loss.

The asset-use test is of primary significance where, for example, interest income

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<sup>3</sup> Code §897(c)(4). See also Code §954(c)(4)(A).

<sup>4</sup> Code §751.

<sup>5</sup> Code §865(e)(2)(A).

<sup>6</sup> Treas. Reg. §1.864-4(c)(1)(i).

*“Under U.S. tax law, a partnership is viewed at times to be a separate entity and at other times to be an aggregate of the partners.”*

is derived from sources within the U.S. by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the U.S., or the asset that is sold was held in a direct relationship to the trade or business conducted in the U.S. A direct relationship exists where the asset was held to meet the present needs of the trade or business and not its anticipated future needs. For example, if an asset is held to meet the operating expenses of a U.S. trade or business, a direct relationship is deemed to exist. In comparison, no direct relationship exists to the U.S. trade or business if the asset is held for the purpose of providing

- future diversification into a new trade or business,
- expansion of trade or business activities conducted outside of the U.S.,
- future plant replacement, or
- future business contingencies.<sup>7</sup>

In comparison, an asset will generally be treated as held in a direct relationship to a U.S. trade or business if

- the asset was acquired with funds generated by that trade or business,
- the income from the asset is retained or reinvested in that trade or business, or
- personnel who are present in the U.S. and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.<sup>8</sup>

The business-activity test ordinarily applies to income or gain that is generally passive but arises directly from the active conduct of the taxpayer's trade or business in the U.S.<sup>9</sup> The business-activity test is of primary significance where (i) dividends or interest are derived by a dealer in stocks or securities, (ii) gain or loss is derived from the sale or exchange of capital assets held in the active conduct of a trade or business by an investment company, (iii) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (iv) service fees are derived in the active conduct of a servicing business.

### **Treatment of Partnership Interests**

To determine whether the gain from the disposition of the partnership interest is U.S. source and, if so, whether it is effectively connected income, the key inquiry is whether the partnership interest is properly treated as an asset that is separate and distinct from the underlying assets of the partnership.

Under U.S. tax law, a partnership is viewed at times to be a separate entity and at other times to be an aggregate of the partners, thereby having no separate legal identity for U.S. income tax purposes.

For purposes of computing ongoing operating income, the Code generally adopts

<sup>7</sup> Treas. Reg. §1.864-4(c)(2)(iv)(a).

<sup>8</sup> Treas. Reg. §1.864-4(c)(2)(iv)(b).

<sup>9</sup> Treas. Reg. §1.864-4(c)(3)(i).

the aggregate approach and the partners are deemed to recognize their distributive shares of partnership income, deductions, and losses as if received directly from the source, thereby ignoring the partnership.<sup>10</sup> Similarly, a partner increases the basis in its partnership interest by its distributive share of partnership income.<sup>11</sup> Distributions of cash to a partner generally are not treated as income, but rather reduce the partner's basis in the partnership interest.<sup>12</sup>

However, for other purposes, the partnership is treated as an entity. Thus, for purposes of computing gain, a partner's interest in the partnership is treated as a capital asset. Therefore, upon a sale of a partnership interest, the partner realizes a capital gain or capital loss.<sup>13</sup> Similarly, a partnership's method of accounting may be different from the method of accounting used by the partners individually. This is acceptable only if the partnership is a separate entity. Consequently, if a partnership computes income under the accrual method of accounting, income is recognized when it sends out a bill. That income is reported by the partnership and passed through for reporting to each partner, even though payment has not been received and each partner uses the cash method of accounting to compute income.<sup>14</sup>

In further illustration, where the partnership is foreign and a partner is a controlled foreign corporation ("C.F.C."), a sale to the partnership of personal property by a party related to the C.F.C. has been held not to be the same as a sale of personal property to the C.F.C. It does not result in the creation of "foreign base company income," which is taxable to a U.S. shareholder of the C.F.C. under Subpart F<sup>15</sup> of domestic tax law except to the extent expressly provided in U.S. tax law or regulations.<sup>16</sup> Such a provision is now expressly provided for in the U.S. income tax regulations.<sup>17</sup> Finally, if a C.F.C. sells an interest in a partnership, the gain is generally treated as an item of "foreign personal holding company income" because the partnership interest is considered to be a passive asset separate and apart from the underlying assets of the partnership.<sup>18</sup> An exception is provided for when the C.F.C. owns 25% or more of the capital or profits interest in the partnership.<sup>19</sup>

At times, the separate entity approach provides for inappropriate treatment for gains derived from the sale of a partnership interest. Examples include (i) gains from the sale of a partnership interest where the partnership assets consist of U.S. real property interests or (ii) inventory assets that have appreciated or depreciable assets that would produce recapture income if they were sold by the partnership. In those circumstances, U.S. tax law either expressly adopts the aggregate approach<sup>20</sup> or

<sup>10</sup> Code §702(b).

<sup>11</sup> Code §705(a)(1).

<sup>12</sup> Code §733.

<sup>13</sup> Code §741.

<sup>14</sup> Treas. Reg. §1.703-1(b)(1).

<sup>15</sup> Code §§951 to 963.

<sup>16</sup> *Brown Group v. Commr.*, 77 F3d 217, (8th Cir. 1996), revg. 104 T.C. 105 (1995).

<sup>17</sup> Treas. Reg. §1.954-1(g)(1), effective for years beginning on or after July 23, 2002.

<sup>18</sup> Code §954(c)(1)(B)(ii).

<sup>19</sup> Code §954(c)(4)(A).

<sup>20</sup> Code §897(c)(4). See also Code §954(c)(4)(A), *id.*



treats the gain as if it produced ordinary income.<sup>21</sup>

The foregoing provisions of U.S. tax law lead to the following conclusion: When a non-U.S. person sells an interest in a partnership that does not own U.S. real property, the gain is covered by the general rule of U.S. tax law that a partnership interest is a capital asset. U.S. law adopts no general rule applicable to all taxpayers or any specific rule applicable to foreign persons under which the partner is treated as if it disposed of its share in the underlying assets of the partnership. Consequently, the gain should not be considered to produce effectively connected income.

## VALIDITY OF REV. RUL. 91-32

### The I.R.S. Position

Notwithstanding the foregoing provisions of U.S. law, the I.R.S. has issued several rulings, in the international context, in which it applied a strict look-thru rule for sales of interests in partnerships. The first, Rev. Rul. 89-85, 1989-2 C.B. 218, involves a C.F.C. that was a partner of a foreign partnership engaged in transactions with a party related to the C.F.C. The ruling holds that a look-thru approach must be adopted under the general principles of U.S. tax law applicable to partnerships and, as a result, the derived foreign base company income that was taxable to the U.S. shareholder of the C.F.C. The fact pattern is identical with the those in *Brown Group v. Commr.*<sup>22</sup> This ruling has no validity in light of the holding in *Brown Group*.

The second, Rev. Rul. 91-32, addressed the taxation of a foreign person who disposed of a partnership interest where the partnership owned assets in the U.S. The ruling considered the gain or loss to be attributable to the global property owned by the L.L.C. This means that to the extent the assets of the U.S. office of the partnership are indirectly sold, the gain from the sale of the partnership interest would be U.S.-source gain considered to be effectively connected income and therefore subject to U.S. Federal income tax. On the other hand, to the extent that the partnership's assets are located outside the U.S., the gain from the sale of the partnership interest would be foreign-source gain that is not effectively connected income. The same conclusion would be reached in the context of an income tax treaty or simply in the context of U.S. domestic tax law. In sum, the I.R.S. applied the aggregate theory of partnerships and looked to Rev. Rul. 89-85 for justification of its application in determining the source and character of partner gain. As a result, the classification of the character of the gain as effectively connected income and the source of the gain as U.S. source would be controlled by the character and source that would be derived by the underlying partnership in a hypothetical sale of all its assets.<sup>23</sup>

In the context of income tax treaties, the I.R.S. has applied the same approach, reasoning that in determining a partner's gain from the disposition of interests in a partnership, it is appropriate to look to a foreign partner's interest in the assets of the partnership. Under this approach, gain or loss realized by a non-U.S. partner upon the disposition of its interest in a partnership that has a U.S. permanent establishment is gain or loss that is attributable to the permanent establishment.

<sup>21</sup> Code §751.

<sup>22</sup> *Supra* note 16.

<sup>23</sup> Code §§865(e)(2) and (3) in conjunction with the look-thru principle under Code §875.

*“When a non-U.S. person sells an interest in a partnership that does not own U.S. real property, the gain is covered by the general rule . . . that a partnership interest is a capital asset.”*

## **Is the I.R.S. Position a Correct Interpretation of the Law?**

While a revenue ruling will be respected by the I.R.S., it is not binding precedent on a court of law. It represents the I.R.S. interpretation of the law, but that interpretation may not be correct.<sup>24</sup> This is illustrated by a case before the U.S. Tax Court, *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commr.*<sup>25</sup> in which the validity of Rev. Rul. 91-32 is the principal issue. The case was tried and briefed in 2014, but no decision has been rendered as of the date of this article.

### **Rev. Rul. 91-32 Analysis Relies on Cases that Have Not Addressed the Issue**

The I.R.S. position expressed in Rev. Rul. 91-32 is unsupported by applicable provisions of U.S. tax law and the case law. The cases cited simply do not make the point hoped for by the I.R.S.

In Rev. Rul. 91-32, the I.R.S. referred to *Unger v. Commr.*<sup>26</sup> in support of the proposition that income from the disposition of a partnership interest by the foreign partner should be attributable to the foreign partner's fixed place of business in the U.S. However, *Unger* did not address that issue. *Unger* addressed the issue of whether gain that is derived by a resident of Canada from a sale of U.S.-situs property by a U.S. partnership engaged in a U.S. business, where the sale is negotiated by the general partner, is taxable to a Canadian resident individual who is a limited partner of the U.S. partnership. That transaction bears no similarity to the transaction considered in Rev. Rul. 91-32 beyond the presence of a Canadian resident and the existence of a U.S. partnership or the equivalent.

*Unger* involved the application of Code §875, under which a foreign person is considered to be engaged in a trade or business within the U.S. if the partnership of which the foreign person is a member is so engaged. In *Unger*, the U.S. partnership actively participated in arranging sales and did so on a regular basis. Thus, the U.S. office of the partnership met the material factor test and the ordinary course requirement for the partnership income to be considered effectively connected income from the sale of personal property.

### **Rev. Rul. 91-32 Is Inconsistent with Code §741**

In Rev. Rul. 91-32, the I.R.S. ignores the plain meaning of Code §741, which codifies the separate entity approach when evaluating the character of gain from the sale of a partnership interest. Code §741 provides as follows:

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

The clear meaning of Code §741 is that a partnership interest is an asset that is separate and apart from an indirect interest in partnership assets.

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<sup>24</sup> See, generally, Linda Galler, “Judicial Deference to Revenue Rulings: Reconciling Divergent Standards,” *Ohio State Law Journal* 4 (1995).

<sup>25</sup> Docket No. 19215-12.

<sup>26</sup> T.C. Memo 1990-15.



In *Pollack v. Commr.*,<sup>27</sup> the Tax Court addressed the application of Code §741 to the sale of a partnership interest. In the case, a management consultant invested \$50,000 to become a limited partner in a venture capital business. The management consultant anticipated that he would get a considerable amount of consulting work out of the fledgling and troubled businesses with which the venture capital firm would be dealing. However, things did not work out as hoped, and the management consultant sold his interest for \$23,000, incurring a loss. He claimed that the loss was an ordinary loss because it related to the underlying business of the partnership. The I.R.S. contended that except in the limited circumstances set forth in Code §751 (and also for F.I.R.P.T.A. purposes), the underlying assets are not relevant in determining the character of the gain derived from the sale of the partnership interest. The court explained that Code §741 was a codification of the partnership entity theory embodied in several pre-1954 cases. The only exception to the separate entity approach was the cross-reference to Code §751, which merely converts capital gain treatment into ordinary income but does not otherwise provide flow-thru treatment for the assets of the partnership to the partners.<sup>28</sup>

Code §751 sets forth the specific partnership items that can cause a capital gain from the sale of a partnership interest to be converted into ordinary income. None of these items are relevant for Rev. Rul. 91-32 purposes. They involve the following:

- Partnership receivables if a partnership reports income under the cash method of accounting and has not reported the profits from the sale
- Recapture under Code §617 of partnership mining exploration expenditures that were previously deducted against ordinary operating income
- Recapture of deferral embedded in shares of stock in a domestic international sales corporation (a “D.I.S.C.”), a form of export subsidy in the U.S.
- Recapture of depreciation under Code §1245 on items of depreciable personal property
- Recapture under Code §1248 of the earnings of a foreign corporation that is a C.F.C.
- Recapture of depreciation under Code §1250 for depreciable real property
- Recapture of soil and water conservation deductions under Code §1252
- Recapture of interests in franchises, trademarks, and trade names under Code §1253 if the selling partner retains certain rights in the intangible property
- Recapture of oil and gas, geothermal, and other mineral properties under Code §1254(a)
- Recapture of market discounts that would be treated as interest income pursuant to Code §1276 in connection with market discount bonds and short-term obligations
- Recapture of deferred rental income under Code §467(c) for economically

<sup>27</sup> 69 T.C. 142 (1977).

<sup>28</sup> Treas. Reg. §1.751-1(a)(2).

accrued but deferred rent

The amount of the gain from the sale of a partnership interest that is treated as ordinary income is based on the recapture that would be mandated under the foregoing provisions as if the listed assets were sold at fair market value in a fully taxable transaction for cash.<sup>29</sup> However, the actual transaction of the taxpayer is not treated as anything other than a sale of the partnership interest.

As a result, Code §741 supports the application of the entity theory of partnerships when dealing with a sale of a partnership interest. Accordingly, whether the gain is effectively connected income is dependent on the activity that gives rise to the sale, not the assets owned by the partnership. The source of the gain will be dependent on the residence of the seller and not the income generated by the assets of the partnership.

#### *Aggregate Approach is Applied Only When Expressly Mandated by Congress*

In comparison to the approach taken by Code §751 – a measuring device for determining the amount of capital gain from the sale of a partnership interest that is converted into ordinary income – Code §897(g) provides a direct look-thru rule when a partnership holds a “U.S. real property interest” and a foreign partner sells or otherwise disposes of an interest in the partnership. Code §897(g) provides as follows:

Under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a non-resident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property.

The regulations appear at Treas. Reg. §1.897-7T(a).

Enactment of Code §897(g) would not have been necessary if the aggregate theory of partnerships were applicable to a sale of a partnership interest, as proposed in Rev. Rul. 91-32. Where Congress believed an exception to the general entity treatment under Code §741 was appropriate, it enacted a specific exception to the entity theory. Because Congress provided for a look-thru rule when it wanted to address a certain problem, it is clear that the absence of a specific aggregate rule for determining source and character of gain on sale of a partnership interest by a foreign partner is intentional. Consequently, the general entity rule of Code §741 should apply to a sale by a foreign partner.

#### *Rev. Rul. 91-32 Fails to Address Case Law Reaching Opposite Conclusion*

There are several cases addressing the aggregate versus entity theory in general. In the absence of abusive tax planning, they hold that the separate entity approach prevails in connection with the treatment of a partnership interest.

*Pollack v. Commr.* has already been discussed. In that case, the I.R.S. argued, and the court confirmed, that the underlying assets of a partnership are not relevant in

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<sup>29</sup> *Id.*

***“The I.R.S. argued, and the court confirmed, that the underlying assets of a partnership are not relevant in determining the character of the gain derived from the sale of the partnership interest.”***

determining the character of the gain derived from the sale of the partnership interest. Code §741 codified the holdings in several cases that pre-dated the Internal Revenue Code of 1954.

*Petroleum Corp. of Texas Inc. v. United States*<sup>30</sup> involved the sale of a partnership interest. In that case, the taxpayer corporation distributed partnership interests to its shareholders in a complete liquidation that was then tax free under the version of Code §336 enacted prior to the 1986 Tax Reform Act. The partnership owned several assets that had been depreciated and would have been subject to depreciation recapture if sold by the partnership.

The taxpayer argued that partnership interests were not listed in the applicable Code sections that dealt with recapture, and therefore, no recapture was required. By contrast, the I.R.S. applied a look-thru approach to impose recapture taxation. The Fifth Circuit adopted the taxpayer's position:

We find it significant that not until well after Taxpayers' liquidating distributions had been made did Congress enact Code Section 386, specifically requiring a corporation which, after March 31, 1984, distributes an interest in a partnership holding recapture property, to recognize its share of gain attributable to such property. Had the enactment of Code Section 386 been merely a codification of existing law, there would have been no reason for Congress to specify, as it did, that the new provision would only be applied prospectively. Thus, the Code provisions were applicable when Taxpayers made the 1983 liquidating distributions of interests in partnerships holding recapture property simply do not support the district court's finding that, for tax purposes, Taxpayers were deemed to have distributed property subject to the Code's recapture provisions. If anything, the enactment of Code Section 386 in its 1984 form, and the way it was enacted with prospective applicability only, confirm Taxpayers' contention that before the subject amendment the law was not as urged by the government.

Another case, *Holiday Village Shopping Center v. United States*,<sup>31</sup> involved a recapture issue very similar to that presented in *Petroleum Corp.* In *Holiday Village*, the taxpayer corporation owned a 99% interest in a partnership that owned and operated residential real property. The partnership had taken accelerated depreciation deductions. The corporation distributed the 99% partnership interest to its shareholders as part of a complete liquidation that qualified for tax-free treatment under the law then in effect, and the taxpayer asserted the depreciation recapture rules then in effect did not apply. By contrast, the I.R.S. asserted a look-thru rule applied so that recapture was required.

The Court of Appeals for the Federal Circuit held for the I.R.S. and applied a look-thru rule, but with an important caveat. The court noted as follows:

Holiday Village also informed us that there were only two partners. The 99 percent interest in the partnership that Holiday Village had, realistically gave it an *owner's interest in the partnership property*

<sup>30</sup> 939 F.2d 1165 (5th Cir. 1991).

<sup>31</sup> 773 F.2d 276 (Fed. Cir. 1985).

*as effectively as if it had owned the property directly. Under these circumstances the partnership should not be viewed as an independent taxable entity wholly separate from and independent of its two partners. [Emphasis added].*<sup>32</sup>

The court's holding in *Holiday Village* was fact-specific and dependent upon the court's determination that the taxpayer's 99% partnership interest was tantamount to complete ownership of the underlying property. The Court of Appeals for the Fifth Circuit in *Petroleum Corp.*, previously discussed, reached a contrary conclusion, distinguishing it from the facts in *Holiday Village* as follows:

We do not intend to create a conflict between this circuit and the Federal circuit when we find *Holiday Village* inapposite to the instant case. Rather, we distinguish this case from *Holiday Village* on the facts. Here, as conceded by the government, all transactions had valid business purposes and were not conceived or entered into in avoidance of taxes. That cannot be said with regard to facts of *Holiday Village*.<sup>33</sup>

The Court of Appeals for the Eleventh Circuit in *Coggin Automotive Corp. v. Commr.*<sup>34</sup> agreed that *Holiday Village* was properly distinguished on the basis of control. In *Coggin*, the taxpayer was a C-corporation that operated as a holding company. *Coggin*, the taxpayer, owned varying majority interests in five subsidiary C-corporations. The five subsidiaries owned six automobile dealerships.

As part of a plan to create six separately controlled businesses, the shareholder of the taxpayer formed six S-corporations, each of which became the general partner of a separate limited partnership. Each of the existing subsidiaries contributed its business assets and liabilities to a separate partnership on the basis of one business to one partnership. Each subsidiary received an interest as a limited partner. The restructuring served several purposes: (i) It assisted in the succession planning for the shareholder; (ii) it supported efforts to retain qualified general managers and key employees of the automobile dealerships by providing ownership incentives; and (iii) it afforded the general managers greater flexibility than the corporate form.

As part of the plan, the subsidiaries were liquidated into the taxpayer, Coggin. The partnerships continued to operate and continued to use the L.I.F.O. (last in, first out) method of accounting. Coggin then made an S-election, and the I.R.S. argued that the L.I.F.O. reserve in the partnerships was subject to recapture under Code §1363(d). The I.R.S. position was posited on two factors: (i) Coggin converted into an S-corporation, and (ii) in the year preceding the election, the partnerships valued inventory under the L.I.F.O. method of accounting.

The I.R.S. argued that the assets of the partnerships were attributed to Coggin, the limited partner, under the aggregate theory of accounting. The Court of Appeals disagreed. According to the court, the partnership owned inventory and Coggin owned partnership interests and no look-thru rule was applicable. In reaching its decision, the Court of Appeals chose to follow the holding in *Petroleum Corp.* over the contrary ruling in *Holiday Village*, stating as follows:

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<sup>32</sup> *Id.*, at 279-280.

<sup>33</sup> *Petroleum Corp.*, 939 F.2d at 1167 n.1.

<sup>34</sup> 292 F.3d 1326 (11th Cir. 2002).



Although the Federal Circuit reached a contrary conclusion on the recapture issue in *Holiday Village*, 773 F.2d at 279, the Fifth Circuit in *Petroleum Corporation* distinguished *Holiday Village* on the basis that there was no legitimate business purpose present in *Holiday Village*, therefore the application of substance-over-form principles was appropriate. *Petroleum Corp.* 939 F.2d at 1167 n.1. We agree.

It is undisputed that the . . . restructuring transaction had economic substance and a valid business purpose. The aggregate theory does not override the clear language of the statute. In accordance with *Petroleum Corporation*, we must follow the statute and not extend it by using judicially-created look-through principles.<sup>35</sup>

In *PDB Sports Ltd. v. Commr.*,<sup>36</sup> the taxpayer was a partnership that owned a professional sports franchise including, among other assets, professional football player contracts. An interest in the partnership had been sold and, following the sale, the partnership adjusted its tax basis in its assets, including the player contracts, pursuant to Code §732(d). The issue presented was whether Code §1056 applied to preclude the basis step-up with respect to the player contracts.

The taxpayer argued that Code §1056 was inapplicable because that provision applies only to sales or exchanges of a sports franchise, and no sports franchise had been sold. The I.R.S. argued for a look-thru of the partnership interest, as if the partnership sold a portion of the interests. The Tax Court declined to apply a look-thru approach, stating as follows:

The absence of express provisions in Code §1056 to address partnership transactions more likely indicates that it does not apply to basis adjustments available to partners who purchase partnership interests.<sup>37</sup>

In *George Edward Quick Trust v. Commr.*,<sup>38</sup> the taxpayer was a trust that had acquired a one-half interest in a partnership from the estate of the decedent who had been a partner in the partnership. The question presented was whether the trust could obtain a step-up in the basis of the partnership interest by reason of Code §1014(a) relating to the fair market value of assets received from a decedent. If the step-up in basis could be obtained, the partnership could elect to have that stepped-up basis pushed down to certain receivables. Since the partnership followed the cash method of accounting, without the step-up, the basis in the receivable was zero.

Code §1014(a) is subject to a limitation relating to income received from a decedent. Pursuant to Code §1014(c), the basis step-up rule of Code §1014 does not apply to the extent the inherited property includes a right to receive an item of income in respect of a decedent (an “I.R.D. item”). The I.R.S. argued that the taxpayer’s right to a share of the partnership’s unrealized receivables constituted an I.R.D. item, thereby causing Code §1014(c) to apply. The taxpayer argued that Code §1014(c) did not apply, because the decedent died owning a partnership interest, rather than

<sup>35</sup> *Id.*, at 1333.

<sup>36</sup> 109 T.C. 423 (1997).

<sup>37</sup> *Id.*, at 437-438.

<sup>38</sup> 54 T.C. 1336 (1970).

directly owning the partnership's unrealized receivables.<sup>39</sup> The Tax Court agreed with the I.R.S.

According to the court, the trust received a partnership interest which included rights to receive partnership income at such time as the receivables were settled by payment. To the court, this was the essence of the stepped-up value and was a classic I.R.D. item. The court also found additional statutory support for its conclusion in Code §751, previously discussed, which converts gain from the sale of a partnership interest into ordinary income to the extent it is attributable to unrealized receivables of the partnership.

### Partnership Anti-Abuse Regulations

In 1995, the I.R.S. adopted certain anti-abuse regulations in the partnership context. These regulations provide that the I.R.S. may treat a partnership as an aggregate if that treatment would carry out the policy of domestic tax law.<sup>40</sup> However, if a clearly articulated policy of the law mandates entity treatment, the anti-abuse rules will not apply. For the reasons expressed above, domestic U.S. tax law mandates entity treatment for sales of partnership interests. Where Congress intended to modify the tax treatment of the sale of a partnership interest, it either broadened the scope of Code §751 or specifically provided for other treatment. Because no express policy has been enacted to limit the scope of entity treatment for the sale of partnership interests, the anti-abuse rules should not mandate a conclusion different from the one mentioned above.

There are strong reasons to apply the separate entity approach:

- It is supported by the plain meaning of Code §741.
- It is supported by the standard under which gains that are effectively connected income are distinguished from gains that are not effectively connected income.
- It is supported by the problem that was addressed by the enactment of Code §897(g) and the limited scope of the solution.
- It is supported by the cases that almost uniformly recognize that a partnership interest is a separate asset.

<sup>39</sup> *Id.*, at 1342.

<sup>40</sup> Treas. Reg. §1.701-2 provides in pertinent part as follows:

(e) Abuse of entity treatment.

- (1) General rule. The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.
- (2) Clearly contemplated entity treatment. Paragraph (e)(1) of this section does not apply to the extent that – (i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and (ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

***“Domestic U.S. tax law mandates entity treatment for sales of partnership interests. Where Congress intended to modify the tax treatment of the sale of a partnership interest, it either broadened the scope of Code §751 or specifically provided for other treatment.”***



## GRECIAN MAGNESITE CASE

The validity of the I.R.S. position has been presented to the I.R.S. in *Grecian Magnesite, Mining, Industrial & Shipping Co., SA v. Commr.*, a case that was tried and briefed in 2014. A final decision has not been issued.

The facts in the case are relatively straightforward:

- Grecian Mining is a privately-owned corporation organized under the laws of Greece.
- From 2001 through 2008, it was a member of a U.S. L.L.C. that was engaged in the business of extracting, producing, and distributing magnesite.
- The business operations were carried on in the U.S.
- In 2008, Grecian Mining's interest in the L.L.C. was completely redeemed, a transaction treated as a sale or exchange of the membership interest.
- Although there were no negotiations as such, whatever discussions took place with the L.L.C. were carried on by officers of Grecian Mining based in Greece.
- The decision to proceed with the redemption was made in Greece, and all documents were signed in Greece.
- Grecian Mining did not maintain an office of its own in the U.S. and did employ individuals located in the U.S.

A portion of the redemption proceeds was properly allocable to appreciation of U.S. real property. The balance related to active business operations that appreciated in value during the period in which Grecian Mining was a member of the L.L.C. Grecian Mining was examined by the I.R.S. and a notice of deficiency was issued by the I.R.S. in 2012 – about the time that an I.R.S. field service advice was issued asserting the validity of the Rev. Rul. 91-32. The I.R.S. asserted that the capital gain was properly treated as effectively connected income because Grecian Mining was engaged in a trade or business as a result of its investment in the L.L.C. Grecian Mining's position is that the assets of the L.L.C. do not control the character of the gain from a disposition of an interest in the L.L.C. Even if it did, the gain is not treated as U.S.-source gain under U.S. tax law<sup>41</sup> and cannot be taxed in the U.S. as effectively connected income under the general rule that foreign-source income cannot be effectively connected income<sup>42</sup> except in three instances<sup>43</sup> that are not relevant to the facts of the case. After almost three years from submission of briefs, the Tax Court has yet to rule on the matter.

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<sup>41</sup> Code §865(a)(2). An exception that applies to sales attributable to a U.S. office that materially participates in a sale is not applicable as no such office existed and could not have engaged in material participation. See Code §865(e)(2)(A).

<sup>42</sup> Code §864(c)(4)(A).

<sup>43</sup> Code §864(c)(4)(B). The exceptions relate to foreign source (i) royalties derived in a licensing business, (ii) dividends, interest, and guarantee fees of a banking, financing, or similar business, and (iii) sales of inventory. In each instance, an office in the U.S. must materially participate in the income-generating transaction.

## CONCLUSION

In Rev. Rul. 91-32, the I.R.S. adopted a view that the rules for characterizing gains from the sale of a partnership interest are different when the partner is not a U.S. person. In so doing, it ignored the clear policy behind Code §741, and asserted that, for a foreign partner, the sale involves a disposition of an indirect share in the underlying assets of the partnership. The weakness in the I.R.S. position is that when Congress enacted Code §897(g) and limited the provision to sales of interests in a partnership owning U.S. real property, it effectively acknowledged that the general rule of Code §741 continued to apply to all other sales. Indeed, when a partnership owns real property and other business property, Code §897(g) affects the real property. The matter will be decided when the Tax Court issues its opinion in *Grecian Magnesite Mining Industrial and Shipping Co SA v. Commr.*



# I.R.S. PUSHES TO EASE IMPLEMENTATION OF COUNTRY-BY-COUNTRY REPORTING FOR U.S. M.N.E.'S

## Authors

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## Tags

B.E.P.S.  
Action 13  
CbC Reporting  
Form 8975  
M.N.E.'s

While the U.S. still refuses to sign onto the O.E.C.D.'s Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (the "CbC M.C.A.A."), the I.R.S. is making progress toward bilateral exchange of tax information. The I.R.S. recently released two model agreements for exchanging country-by-country ("CbC") reporting information – one based on tax treaties and the other based on Tax Information Exchange Agreements ("T.I.E.A.'s") – and in May, it confirmed that the U.S. signed its first bilateral competent authority agreement. To date, agreements have been signed with 12 jurisdictions: Canada, Denmark, Guernsey, Iceland, Ireland, Korea, Latvia, the Netherlands, New Zealand, Norway, Slovakia, South Africa.<sup>1</sup> The U.S. is currently negotiating additional agreements in the hope of enabling U.S. multinationals to file CbC reports for 2016 with the I.R.S., rather than with foreign jurisdictions.

## COMPARISON OF U.S. AND O.E.C.D. REGIMES

On June 30, 2016, the I.R.S. published final regulations<sup>2</sup> that require annual CbC reporting by U.S. persons that are ultimate parent entities of a multinational enterprise ("M.N.E.") group that has annual revenue for the preceding annual accounting period of \$850 million or more. This action followed proposed I.R.S. rulemaking published as a direct response to the O.E.C.D.'s final B.E.P.S. reports issued in October 2015, which included recommendations for Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting), according to which M.N.E.'s with annual consolidated group revenues equal to or exceeding €750 million will submit a standardized report.

The standardized report, at the minimum, should include (i) a master file with high-level information about global operations and transfer pricing policies, (ii) a local file with detailed transactional transfer pricing documentation that is specific to each country, and (iii) an annual CbC report that includes more detailed information about each jurisdiction where the business is conducted. While the O.E.C.D. recommended that the master and local reports be filed directly with an entity's local tax administration, it called for the annual CbC report to be filed in the jurisdiction of the tax residence of the ultimate parent entity and shared between taxing jurisdictions through the CbC M.C.A.A., a bilateral tax treaty, or a Tax Information Exchange Agreement ("T.I.E.A.").

To date, 57 countries have signed on to the CbC M.C.A.A. and are publishing local guidance on CbC reporting – the U.S. is not among the 57. The O.E.C.D.

<sup>1</sup> Agreement status, including available texts, can be found on the I.R.S. website; see [Country-by-Country Reporting Jurisdiction Status Table](#).

<sup>2</sup> See Treas. Reg. §1.6038-4.

*“The I.R.S. allows U.S. parent companies to file voluntary CbC reports for periods beginning on or after January 1, 2016, but before June 30, 2016, and is working to reach agreements with many foreign jurisdictions to facilitate exchanges.”*

recommendation for implementation of Action 13 calls for CbC reporting for fiscal years beginning on or after January 1, 2016. However, according to local guidance, some countries have deviated from this date. For example, Switzerland will require reporting for fiscal years beginning on or after January 1, 2018, but will allow reporting to be filed voluntarily for years beginning in 2016 to avoid exposure to penalties or other consequences in countries where CbC reporting begins earlier.<sup>3</sup>

The final I.R.S. regulations are effective as of June 30, 2016, the date of publication in the Federal Register. Therefore, U.S. parent entities of M.N.E. groups that use a calendar year as their taxable year generally will not be required to file a CbC report with the I.R.S. for the taxable year beginning January 1, 2016; the initial reporting period for such entities will be for the year beginning January 1, 2017. However, as mentioned above, many jurisdictions will require filing for 2016, and thus, entities that are members of a U.S. M.N.E. group may be subject to CbC reporting requirements outside the U.S. prior to the date applicable to the U.S. reporting requirement.

If the ultimate parent entity resides in a jurisdiction that has a CbC reporting requirement for the same annual period as requested by a local foreign jurisdiction, an M.N.E. member resident in such jurisdiction will not be required to file separately in that jurisdiction. Accordingly, the I.R.S. allows U.S. parent companies to file voluntary CbC reports for periods beginning on or after January 1, 2016, but before June 30, 2016, and is working to reach agreements with many foreign jurisdictions to facilitate exchanges of such disclosures. These efforts have resulted in 12 agreements signed within the past month. All of these signed agreements, except the one signed with Iceland, contain language similar to that in Section 3(2) of the model agreement for exchanging CbC reporting information, which provides that first the exchange is intended to take place with respect to fiscal years beginning on or after January 1, 2016. This language indicates that voluntary filings with the I.R.S. with respect to 2016 will be respected by partner jurisdictions.

Additionally, CbC reports filed with the I.R.S. and exchanged pursuant to a competent authority agreement benefit from confidentiality requirements, data safeguards, and appropriate use restrictions under the agreement, which the I.R.S. is committed to monitor.

## U.S. REPORTING: FORM 8975, COUNTRY-BY-COUNTRY REPORT

The information requirement provided for in the regulations will be satisfied by submitting a new reporting form – Form 8975, *Country-by-Country Report* – with the income tax return for the year reported. To date, only a draft form and draft instructions are available.

As mentioned above, the first required U.S. reporting period is 2017. The time to file is the due date for that income tax return, including extensions.

Form 8975, which must be filed by the ultimate parent entity of the U.S. M.N.E. group, must include Schedule A, *Tax Jurisdiction and Constituent Entity Information*, for each tax jurisdiction in which the group has one or more business entities. In

<sup>3</sup> See the O.E.C.D. website for [Country-Specific Information on Country-by-Country Reporting Implementation](#).

general, Schedule A lists the group's business entities (*i.e.*, constituent entities) and reports, on a CbC basis, items such as related and unrelated party revenue, profit before income tax, income tax paid on a cash basis, income tax accrued, stated capital, accumulated earnings, number of employees, non-cash tangible assets, jurisdictions of organization and residence, and primary business activity by entity.

### **U.S. M.N.E. Group**

A U.S. M.N.E. group is a group of entities whose ultimate parent entity is a U.S. entity. The U.S. M.N.E. group is comprised of the ultimate parent company and all business entities that are required to consolidate their accounts with the parent under U.S. generally accepted accounting principles ("G.A.A.P.").

An ultimate parent entity of a U.S. M.N.E. group is a U.S. entity that owns, directly or indirectly, a sufficient interest in one or more other business entities, at least one of which is organized or tax resident outside the U.S., such that the U.S. business entity

- is required to consolidate the accounts of the other business entities with its own accounts under U.S. G.A.A.P., and
- is not owned, directly or indirectly, by another business entity that consolidates the accounts of the U.S. business entity with its own accounts under G.A.A.P. in another jurisdiction.

A "business entity" is any entity other than a trust, including a disregarded entity and any permanent establishment ("P.E.") that prepares financial statements separately from its owner for financial or tax reporting, regulatory, or internal management control purposes. A grantor trust owned by a person other than an individual is also considered a business entity.

### **Constituent Entity**

A constituent entity of a U.S. M.N.E. group is defined as any separate business entity in the group, except a corporation or partnership for which a Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, or Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*, is not required to be filed.

Note that if any entity is consolidated under U.S. G.A.A.P. and therefore included in the U.S. M.N.E. group, it will also be controlled and subject to reporting on the appropriate above-mentioned form. However, in some cases (*e.g.*, variable interest entities where the investor has a controlling interest in the value but not the vote), an entity may be consolidated under U.S. G.A.A.P. and not controlled for other reporting purposes.

### **P.E.**

Under the regulations, a P.E. includes any of the following:

- A branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a P.E. under an income tax treaty
- A branch or business establishment of a constituent entity that is liable to tax in the tax jurisdiction in which it is located pursuant to the domestic law of

such jurisdiction

- A branch or business establishment of a constituent entity that is treated as an entity separate from its owner by the owner's tax jurisdiction of residence

### **Tax Residence**

A business entity is resident in a tax jurisdiction if it is subject to tax under the laws of that country (the "subject-to-tax test"), provided that the tax is not imposed solely with respect to income from sources in that jurisdiction or capital situated in that jurisdiction and provided that such tax is not imposed solely on a gross basis. A corporation that is organized or managed in a tax jurisdiction that does not impose an income tax on corporations will be treated as resident in that tax jurisdiction unless treated as resident in another jurisdiction under the subject-to-tax test. A P.E., on the other hand, is resident in the jurisdiction in which it is located. If the residency of an ultimate parent of a U.S. M.N.E. group cannot be determined by the subject-to-tax test, then residency shall be determined by its country of organization.

A business entity that does not have a tax residence under the subject-to-tax test is considered "stateless" for reporting purposes. Information for stateless entities is reported on an aggregate basis for all stateless entities in a U.S. M.N.E. group. Note that under the residence test, entities that are treated as partnerships in the jurisdiction in which they were organized will not be subject to tax in such jurisdiction and thus will be treated as stateless (for purposes other than for determining their status as an ultimate parent entity of a U.S. M.N.E.) under the general rule, unless they create a P.E. in that or another jurisdiction.

Each stateless entity's owner reports its share of the stateless entity's revenue and profits in the owner's tax jurisdiction of residence, regardless of whether the stateless entity's owner is liable for tax on that income in such jurisdiction (*i.e.*, regardless of whether the owner's country residence treats the stateless entity as a separate entity for tax purposes or not).

If an entity has a residence in more than one jurisdiction, then applicable income tax treaty rules should determine residency. If no treaty provisions apply, residency will be determined based on the entity's place of effective management in accordance with the O.E.C.D.'s model treaty or as provided in Form 8975. Note that the draft Form 8975 is silent on that point.

### **Surrogate Entity**

A foreign parent of an M.N.E. group cannot designate a U.S. business entity that it controls to be a "surrogate entity" for filing purposes. However, a U.S. parent can designate another U.S. business entity that it controls to be surrogate parent entity and file on its behalf.<sup>4</sup>

### **Confidentiality & Exchange of Information with Non-U.S. Jurisdictions**

Transfer pricing adjustments will not be made solely based on the CbC report, but the report may serve as a basis for further inquiries into transfer pricing practices or other matters that may lead to adjustments.<sup>5</sup>

<sup>4</sup> Treas. Reg. §1.6038-4(j).

<sup>5</sup> I.R.S., "Country-By-Country Reporting," REG-109822-15, December 23, 2015.



Persons that have access to a return are prohibited from disclosing information about the return.<sup>6</sup> “Return information” includes information such as, *inter alia*, the taxpayer’s identity, sources and amounts of the taxpayer’s income, the taxpayer’s net worth, whether the return is being examined, the taxpayer’s possible liability, or any written determination or background file document that is not open to public inspection.<sup>7</sup>

State agencies can access the CbC report to assess state taxes.<sup>8</sup> Disclosures are permitted to persons designated by the taxpayer, congressional committees, tax administrators, and Federal departments for statistical use.<sup>9</sup>

If a U.S. government employee knowingly or negligently discloses any return or return information, the taxpayer can bring a civil action against the U.S. government.<sup>10</sup> The taxpayer can also bring a civil action case against a non-employee if the non-employee discloses the taxpayer’s identity or information.<sup>11</sup> The taxpayer must commence the action two years after discovering the disclosure.<sup>12</sup> If the taxpayer’s claim prevails, the taxpayer may be entitled to the costs of the action, plus possible damages.<sup>13</sup> A willful disclosure may also be punishable with a felony conviction.<sup>14</sup>

## CONCLUSION

Numerous multinational businesses – such as McDonalds, Starbucks, and Google – have been “named and shamed” in European State Aid cases for possibly engaging in overly-aggressive tax planning.<sup>15</sup> These types of incidents have caused U.S. companies to be wary of direct information disclosures to foreign governments, which could result in their information being released by those governments for partisan political purposes. While the U.S. has not signed onto the CbC M.C.A.A., the 12 agreements signed in the last month demonstrate a U.S. commitment to negotiating bilateral sharing agreements that align with the interests of U.S. businesses. It is expected that I.R.S. efforts to conclude as many agreements as possible prior to the date for filing the 2016 tax return (for U.S. entities that are filing their return on an extension) will enable U.S. M.N.E. groups to file CbC reports with the I.R.S. and thus enjoy the confidentiality that the I.R.S. is committed to promote.

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<sup>6</sup> Code §6103(a).

<sup>7</sup> Code §§6103(b)(2), 6110.

<sup>8</sup> Code §6103.

<sup>9</sup> Code §§6103(c)-(f), (h).

<sup>10</sup> Code §7431(a).

<sup>11</sup> Code §7431(a)(2).

<sup>12</sup> Code §7431(d).

<sup>13</sup> Punitive damages may be assessed if the disclosure was willful or the result of gross negligence (Code §7431(c)).

<sup>14</sup> Code §7213(a).

<sup>15</sup> Kenneth Lobo, “McDonalds Accused of Re-routing Royalty Payments to Avoid Billions in European Taxes,” *Insights* 3 (2015); Beate Erwin and Christine Long, “E.U. State Aid—The Saga Continues,” *Insights* 6 (2016).

# NEW PROPOSAL FOR SWISS CORPORATE TAX REFORM

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## Tags

Corporate Tax  
Notional Interest Deduction  
Patent Box  
Switzerland

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## INTRODUCTION

Following up on our recent article on Swiss corporate tax reform,<sup>1</sup> the Steering Committee representing the cantons and Swiss Federation issued its recommendation regarding the implementation of a modified corporate tax reform to the Swiss Federal Council on June 1, 2017. The corporate tax reform has been renamed the Tax Proposal (“T.P. 17”) and is, in general, based on the Corporate Tax Reform III (“C.T.R. III”), which was rejected on February 12, 2017, by Swiss voters.

The Steering Committee met representatives of cities, municipalities, political parties, business associations, and labor unions in order to achieve a more balanced, transparent, and politically accepted corporate tax reform. Compared to the C.T.R. III, the package has been adjusted and now also includes a social component. As expected, the preferred tax regimes provided by Swiss law will be abolished and the main goals of the reform remain the same (*i.e.*, to maintain Switzerland as an attractive and competitive business and tax location, to be in line with international best practices, and to generate sustainable tax revenues). This article summarizes the most important differences between the C.T.R. III and T.P. 17.

## PROPOSED ADJUSTMENTS

### Notional Interest Deduction

While the C.T.R. III included a deemed interest deduction on excessive shareholder’s equity – known as a notional interest deduction (“N.I.D.”) – this measure is not included in the new proposal. Since this measure was one of the most debated items in the C.T.R. III, the exclusion was expected. Swiss finance branches (*i.e.*, branches of a foreign company providing finance services to group members) will face higher corporate income tax rates, since they will be subject to ordinary taxation on a cantonal/municipal level and no additional deduction for extra equity will be granted.

### Patent Box

The introduction of a cantonal/municipal level intellectual property (“I.P.”) or “Patent Box” regime, based on the O.E.C.D. nexus approach, is also included in the new proposal. Compared to the C.T.R. III the Patent Box will, however, not include patented software. Therefore, software companies will not be able to benefit fully from tax relief granted by the Patent Box regime.

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<sup>1</sup> See Peter von Burg and Natalie Peter, “Swiss Corporate Tax Reform Postponed.” *Insights* 2 (2017).





### **Deduction for Research and Development**

In addition to the Patent Box regime, the C.T.R. III provided for an optional deduction of 50% for research and development (“R&D”) costs incurred in Switzerland. This optional deduction is included in the T.P. 17 as well. However, the Steering Committee emphasized that the deduction should be limited to personnel expenses. Fees to contract research organizations may not generate the enhanced tax benefit.

### **Introduction of an Overall Limitation of Tax Reduction at the Cantonal Level**

The measures provided for by the C.T.R. III would have allowed for up to an 80% reduction of taxable profits at the cantonal/municipal level. However, the T.P. 17 has restricted the reduction. Provided a company will be able to benefit from multiple measures of the new proposal, the total reduction will be limited to 70%. Hence, such companies will face slightly higher corporate income tax rates.

### **Income Tax Rates**

As under the C.T.R. III, it will still be at the discretion of the cantons to decrease cantonal/municipal corporate income tax rates. However, the minimum taxation of qualifying dividend income earned by individuals must be at least 70% under the T.P. 17, whereas under the C.T.R. III the minimum taxation was 60%. This increased taxation of dividend income earned by individuals will mainly impact owners of small- and medium-sized entities (“S.M.E.’s”) and will lead to a slightly higher total income taxation.

### **Family Allowance**

The minimum amount for the family allowance will be increased to CHF 230 for child allowance and CHF 280 for education allowance. Most of the cantons will need to raise payments to comply with the new minimum standards. This measure introduces a social component into the reform that was not part of C.T.R. III.

## **OUTLOOK**

In general, the need for tax reform is undisputed, and it is expected that, following discussion by the Federal Council and the Swiss parliament, the above-mentioned proposals will be included in the final bill. As mentioned above, the removal of the N.I.D. should not generate further discussion, and the N.I.D. most likely will not be included in the final reform. The other proposals discussed above include only small changes to the reform proposals of C.T.R. III and some adjustments may be made after discussion by the Federal Council and the Swiss parliament. Finally, the proposal to increase the family allowance may be questioned by center or right-wing parties, since it is not connected to corporate taxation.

The step-up mechanism – imposing a tax on the realization of undisclosed hidden reserves and self-generated goodwill at a special low tax rate during a transitional period – is not explicitly addressed by the T.P. 17. However, it is anticipated that this mechanism will still be applied for a transitional period.

The T.P. 17 is only in its initial stage. The expected timeline provides that the Federal Council will confirm or adjust the T.P. 17 in June. It is further expected that the Swiss Federal Department of Finance will prepare the draft bill, which will undergo

consultation by the end of this year. If all goes well, the Swiss parliament will adopt the bill in the spring of 2018. Subject to the consensus among all parties, no additional voting on the reform is likely, provided that sufficient signatures to a request for referendum are not gathered. Because the cantons must join the Federal government through the adoption of the proposals under cantonal law, it is expected that the reform will come into force on the 1st of January 2020 or 2021.

*“The T.P. 17 is only in its initial stage. . . . If all goes well, the Swiss parliament will adopt the bill in the spring of 2018.”*

# I.R.S. BREAKS THE SILENCE WITH REV. RUL. 2017-09, ISSUES GUIDANCE ON “NORTH-SOUTH” TRANSACTIONS

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## Tags

Code §355  
Distributions  
North-South Transactions

On May 3, 2017, the I.R.S. issued Rev. Rul. 2017-09, 2017-21 I.R.B. 1244, which clarifies “north-south” transactions in two factual situations. This ruling reverses the I.R.S. no ruling position on north-south transactions that was issued in 2013.<sup>1</sup> A north-south transaction involves to a transfer of stock, money, or other property by a person to a corporation and a transfer of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions, at least one of which is a distribution with respect to the corporation’s stock, a contribution to the corporation’s capital, or an acquisition of stock.

## BACKGROUND

Generally, a dividend distribution made by a corporation to a shareholder with respect to its stock is includible in the gross income of the shareholder.<sup>2</sup> The portion of the distribution that is not a dividend is applied against and reduces the adjusted basis of the stock,<sup>3</sup> while the portion of the distribution that is not a dividend, to the extent that it exceeds the adjusted basis of the stock, is treated as gain from the sale or exchange of property.<sup>4</sup> If a corporation distributes appreciated property to a shareholder in a distribution to which Code §301 applies, gain (but not loss) is recognized to the distributing corporation as if it had sold the property to the shareholder at fair market value.<sup>5</sup>

No gain or loss is recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.<sup>6</sup> Furthermore, if certain requirements are met, a corporation may distribute stock and securities of a controlled corporation to its shareholders and security holders without recognizing gain or loss (“nonrecognition treatment”) or income to the recipient shareholders or security holders.<sup>7</sup>

For a distribution to qualify for nonrecognition treatment, the distributing corporation must distribute stock or securities of a corporation it controls before the distribution.<sup>8</sup> A distribution will qualify for non-recognition treatment only if the distributing

<sup>1</sup> Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

<sup>2</sup> Code §301(c)(1).

<sup>3</sup> Code §301(c)(2).

<sup>4</sup> Code §301(c)(3).

<sup>5</sup> Code §311(b).

<sup>6</sup> Code §351(a).

<sup>7</sup> Code §355(a)(1).

<sup>8</sup> Code §355(a)(1)(A).



corporation distributes an amount of stock in the controlled corporation constituting control within the meaning of Code §368(c).<sup>9</sup> “Control” is defined as ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.<sup>10</sup> The distributing corporation and the controlled corporation each must be engaged in the active conduct of a trade or business immediately after the distribution.<sup>11</sup>

No gain or loss is recognized to a corporation that is a party to a reorganization upon exchange of property in pursuance of a plan of reorganization solely for stock or securities in another corporation that is also a party to the reorganization.<sup>12</sup> The definition of “reorganization” includes a transfer by a corporation of part of its assets to another corporation if, immediately after the transfer, the transferor is in control of the corporation to which the assets are transferred and the transferor distributes the stock in a transaction that qualifies under Code §§354, 355, or 356.<sup>13</sup> If property received in an exchange consists not only of stock or securities of the acquiring corporation but also other property or money (*i.e.*, “boot”) and it is received in pursuance of a plan of reorganization, the corporation does not recognize gain from the exchange. However, if the corporation receiving the boot does not distribute it in pursuance of a plan of reorganization, any gain that the corporation realizes on the exchange of its property is recognized up to the amount and the fair market value of the boot that is not distributed.<sup>14</sup> If the acquiring corporation distributes property other than qualified property and the fair market value of such property exceeds its adjusted basis, then gain will be recognized as if such property were sold to the distributee at its fair market value.<sup>15</sup>

The gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in Code §1011 for determining gain, and the loss is the excess of the adjusted basis for determining loss over the amount realized.<sup>16</sup> Unless an exception applies, the entire amount of the gain or loss that was determined under Code §1001 is recognized on the sale or exchange of the property.<sup>17</sup>

No gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.<sup>18</sup> The underlying assumptions of these exceptions to the recognition of gain or loss under Code §1001 are that the new property is substantially a continuation of the old, still unliquidated investment or, in the case of a reorganization, that the new enterprise, the new corporate structure, and the new property are substantially continuations of

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<sup>9</sup> Code §355(a)(1)(D)

<sup>10</sup> Code §368(c).

<sup>11</sup> Code §355(b)(1)(A)

<sup>12</sup> Code §361(a)

<sup>13</sup> Code §368(a)(1)(D).

<sup>14</sup> Code §361(b)

<sup>15</sup> Code §361(c)(2)(A).

<sup>16</sup> Code §1001(a).

<sup>17</sup> Code §1001(c).

<sup>18</sup> Code §1232(a).

the old, still unliquidated structure.<sup>19</sup>

In prior rulings, the I.R.S. held that the requirement under Code §355(b)(1)(A) that the distributing corporation be engaged in an active trade or business was satisfied where the distributing corporation was (i) an inactive holding company and (ii) a subsidiary of the distributing corporation engaged in a Code §332 liquidation for the purpose of transferring its active trade or business to the distributing corporation.<sup>20</sup>

In 2013, the I.R.S. issued a ruling where a person (the “Transferor”) transferred assets to a corporation (the “First Corporation”) in exchange for an amount of stock in the First Corporation constituting control (the “First Transfer”).<sup>21</sup> Pursuant to a binding agreement entered into by the Transferor with a third party prior to the First Transfer, (i) the Transferor transferred the stock of the First Corporation (the “Second Transfer”) to another corporation (the “Second Corporation”); (ii) the third party transferred money to the Second Corporation (the “Third Transfer”); and (iii) the Second Corporation transferred the money it received from the third party to its wholly owned subsidiary, the First Corporation. Immediately after these transactions, the Transferor and the third party were in control of the Second Corporation and the Second Corporation was in control of the First Corporation. The I.R.S. ruled that the First Transfer satisfied the control requirement of Code §351(a), notwithstanding the Second Transfer. The I.R.S. concluded that the Second Transfer, a nontaxable disposition of the stock received in the First Transfer, was not inconsistent with the purposes of Code §351 because the transaction lacked the characteristics of a sale and the Transferor retained beneficial ownership in the assets transferred to the First Corporation.

In *Estates of Bell*, the Tax Court explained that sales of assets between a taxpayer’s wholly owned subsidiaries followed by liquidating distributions “literally comply with the provisions of the Code dealing with complete liquidations . . . but in substance accomplish a reorganization coupled with the distribution of a dividend.”<sup>22</sup> The court went on to state that, because Code §356 is “the exclusive measure of dividend income provided by Congress where money is distributed to shareholders as an incident of a reorganization,” Code §§301 and 1.3011(l) were not applicable to the acquisitive reorganization under Code §368(a)(1)(D).

## NEW GUIDANCE

The I.R.S. raised two issues in the Rev. Proc. 2007-09:

- If a parent corporation (“P”) transfers property (including property constituting an active trade or business that is transferred for the purpose of meeting the requirements of Code §355(b)(1)(A)) to its subsidiary (“D”) and, pursuant to the same overall plan, this transfer is followed by a distribution by D of the stock of its controlled subsidiary (“C”) to P, are the transactions treated, for Federal income tax purposes, as an exchange under Code §351 followed by a distribution under Code §355?

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<sup>19</sup> Treas. Reg. §1.1002-1(c).

<sup>20</sup> Rev. Rul. 74-79, 1974-1 CB 81.

<sup>21</sup> Rev. Rul. 200351, 2003-1 C.B. 938,

<sup>22</sup> *Estates of Bell v. Commr.*, [1971 PH TC Memo ¶71,285] T.C. Memo 1971285

- Is a transfer of money or other property by C to D, made in pursuance of a plan of reorganization under Code §368(a)(1)(D) and Code §355, governed by Code §§301 or 361?

To answer these issues, Rev. Proc. 2017-9 provides two explanatory scenarios.

### **Situation 1 Facts**

P owns all the stock of D, which owns all the stock of C. The fair market value of the C stock is \$100X. P has been engaged in Business A for more than five years, and C has been engaged in Business B for more than five years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of Code §355(b). D is not engaged in the active conduct of a trade or business, directly or through any member of its separate affiliated group (within the meaning of Code §355(b)(3)) other than C.

On Date 1, P transfers the property and activities constituting Business A, having a fair market value of \$25X, to D in exchange for additional shares of D stock. On Date 2, pursuant to a dividend declaration, D transfers all the C stock to P for a valid corporate business purpose. D retains the Business A property and continues the active conduct of Business A after the distribution. The purpose of P's transfer of the property and activities of Business A to D is to allow D to satisfy the active trade or business requirement of Code §355(b)(1)(A).

### **Situation 1 Analysis**

The Federal income tax consequences to P and D in Situation 1 depend on whether the Date 1 and Date 2 transfers are treated as separate transactions. Because they are undertaken pursuant to the same overall plan, a question arises as to whether the two transactions are part of a single reciprocal transfer of property – an exchange.

If the Date 1 and Date 2 transfers are respected as separate transactions for Federal income tax purposes, P would be treated as transferring property to D on Date 1 for D stock, in an exchange to which Code §351 applies, and D would be treated as distributing all the stock of C to P on Date 2, in a distribution to which Code §355 applies (assuming the requirements under those Code sections are otherwise satisfied).

If the Date 1 and Date 2 transfers are integrated into a single exchange for Federal income tax purposes, P would be treated as transferring its Business A property to D in exchange for a portion of the C stock, in an exchange to which Code §1001 applies. In such an exchange, gain or loss would be recognized to P on the transfer of its property to D; gain or loss would be recognized to D, under Code §1001(a), upon its transfer of 25% of the C stock to P in exchange for the property transferred to it. In addition, Code §355 would not apply to any part of the distribution of C stock because D would not have distributed stock constituting Code §368(c) control of C. Gain would be recognized to D, under Code §311(b), upon the distribution of the remaining 75% of the C stock with respect to P's stock in D to which Code §301 would apply.

The determination of whether steps of a transaction should be integrated requires a review of the scope and intent underlying each of the implicated provisions of the Code. The tax treatment of a transaction generally follows the taxpayer's chosen

***“Back-to-back nonrecognition transfers are generally respected when they are consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy.”***

form unless (i) there is a compelling alternative policy, (ii) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise applicable Code provisions, or (iii) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions.<sup>23</sup> Code §§355(b)(2)(C) and (D) permit the direct and indirect acquisition of an active trade or business by a corporation within the five-year period ending on the date of a distribution in transactions in which no gain or loss was recognized. The intent of Code §§355(b)(2)(C) and (D) is to prevent the acquisition of a trade or business by the distributing corporation or the controlled corporation from an outside party in a taxable transaction within the five-year pre-distribution period.<sup>24</sup> These provisions ensure that transfers of assets in transactions eligible for nonrecognition treatment (nonrecognition transactions) throughout the five-year period will not adversely impact an otherwise qualifying Code §355 distribution. This principle is illustrated in Rev. Rul. 74-79 in which an active trade or business was transferred to a distributing corporation in a Code §332 liquidation to satisfy the requirements of Code §355(b).

The transfer of property permitted to be received by D in a nonrecognition transaction has independent significance when undertaken in contemplation of a distribution by D of stock and securities described in Code §355(a)(1)(A). The transfer thus is respected as a separate transaction, regardless of whether the purpose of the transfer is to qualify the distribution under Code §355(b).<sup>25</sup> Back-to-back nonrecognition transfers are generally respected when they are consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy.<sup>26</sup>

P's transfer on Date 1 is the type of transaction to which Code §351 is intended to apply. Analysis of the transaction as a whole does not indicate that P's transfer should be properly treated other than in accordance with its form. Each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed. On these facts, nonrecognition treatment under Code §§351 and 355 is not inconsistent with the congressional intent of these Code provisions. The effect of the steps in Situation 1 is consistent with the policies underlying Code §§351 and 355. Accordingly, the Date 1 and Date 2 transfers described in Situation 1 are respected as separate transactions for Federal income tax purposes. Therefore, Code §351 applies to P's transfer on Date 1, and Code §355 applies to D's transfer on Date 2.

The Federal income tax consequences would be the same (qualification under Code §355) if, instead of acquiring an active trade or business in a Code §351 transfer from P to D, D acquired an active trade or business from a subsidiary of P in a

<sup>23</sup> *H.B. Zachry Co. v. Commr.*, 49 T.C. 73 (1967); *Makover v. Commr.*, T.C. Memo 196753 [¶67,053 P.H. Memo T.C.]; Rev. Rul. 78330, 19782 C.B. 147. Code §§351, 355, and 368 generally allow continued ownership of property in modified corporate form without recognition of gain. See *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655 [13 AFTR 1052] (5 Cir. 1934), cert. denied, 293 U.S. 607 (1934); Treas. Reg. §1.10021(c); Rev. Rul. 2003-51.

<sup>24</sup> Rev. Rul. 78442, 19782 C.B. 143 (holding that Code §357(c) gain arising from a Code §351 transfer of an active trade or business does not violate Code §355(b)(2)(C)).

<sup>25</sup> Rev. Rul. 78330; Treas. Reg. §1.3556(d)(3)(v)(B), Example 1; and *Athanasios v. Commr.*, T.C. Memo 199572 [1995 RIA T.C. Memo ¶95,072].

<sup>26</sup> Rev. Rul. 20159, 201521 I.R.B. 972; Rev. Rul. 201510, 201521 I.R.B. 973.

cross-chain reorganization under Code §368(a)(1).<sup>27</sup>

### **Situation 2 Facts**

P owns all the stock of D, which owns all the stock of C. D has been engaged in Business A for more than five years. C has been engaged in Business B for more than five years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of Code §355(b).

On Date 1, C transfers funds amounting to \$15X and property having a fair market value of \$10X to D, pursuant to a dividend declaration, and D retains the money and property. On Date 2, D transfers property having a basis of \$20X and a fair market value of \$100X to C, and D distributes all the C stock to P in a transaction qualifying as reorganization under Code §§368(a)(1)(D) and 355. C and D planned and executed the Date 1 transfer in pursuance of a plan of reorganization.

### **Situation 2 Analysis**

If the distribution by C of money and other property on Date 1 is treated as separate from the distribution of C stock, Code §301 would apply to D's receipt of the money and other property from C, and no gain would be recognized to D upon the transfer of property to C. However, if the Date 1 distribution is treated as occurring in pursuance of a plan of reorganization under Code §§368(a)(1)(D) and 355 that includes the Date 2 distribution of C stock, the money and other property distributed by C to D would constitute boot to D, and under Code §361(b)(1)(B), gain would be recognized to D on its transfer of property to C to the extent of the amount of the funds and the fair market value of the property. Code §361(b) requires gain recognition to D if boot is distributed to D and not further distributed by D to its shareholders or creditors in pursuance of a plan of reorganization unless the facts establish that the distribution is in substance a separate transaction.<sup>28</sup>

As noted above, in *Estates of Bell* the Tax Court explained that the boot rules are “the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization.” Code §361 broadly looks to whether transfers of money or other property occur “in pursuance of the plan of reorganization” or “in connection with the reorganization.” Here, the distribution is made in pursuance of the plan of reorganization. A distribution of money and other property in pursuance of a plan of reorganization will be treated as boot subject to recognition of gain, consistent with the congressional intent underlying Code §361. Therefore, the Federal income tax treatment of the transaction will follow its substance, and the distribution of money and property by C to D will constitute a distribution of boot under Code §361(b).

## **CONCLUSION**

In Situation 1, the taxpayer's form was respected. The transfer by P to its subsidiary, D, of property immediately followed by the distribution by D to P of the stock of its controlled subsidiary, C, is treated as an exchange to which Code §351 applies,

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<sup>27</sup> See Rev. Rul. 74-79

<sup>28</sup> Cf., Rev. Rul. 71364, 19712 C.B. 182 (finding that a distribution of money declared and paid following a reorganization exchange is treated as boot in the reorganization).



followed by a distribution of C stock to which Code §355 applies. Conversely, in Situation 2, the taxpayer's form was not respected. Code §361, and not Code §301, applies to the transfer of money or other property by C to D made in pursuance of a plan of reorganization under Code §§368(a)(1)(D) and 355.

According to Rev. Proc. 2017-9, the taxpayer first must determine, under existing Code provisions and case law, whether the two transactions occur pursuant to one plan. Once it is determined, the tax treatment of a transaction will follow the taxpayer's chosen form unless (i) there is a compelling alternative policy, (ii) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise applicable Code provisions, or (iii) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions. This clarification provides useful guidance for a taxpayer planning to execute a north-south transaction and perhaps other multi-step transactions, as well.



## UPDATES AND TIDBITS

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### Tags

Exchange of Financial  
Information  
I.T.I.N.  
France  
Tax Reform  
U.S.

### OBTAINING AN I.T.I.N. – BACK TO “GOOD OLD TIMES” FOR FOREIGN APPLICANTS

When claiming a refund of over-withheld tax, purchasing or selling real property, or complying with U.S. filing requirements, a non-U.S. individual is required to obtain an individual taxpayer identification number (“I.T.I.N.”) from the I.R.S. Prior to late December 2016, certifying acceptance agents (“C.A.A.’s”) could facilitate this process by verifying the accuracy of the information, authenticating the identity of the foreign applicant in the applicant’s home country, and filing the application with the I.R.S. on the applicant’s behalf. Effective December 19, 2015, the rules relating to foreign-based certifying acceptance agents were changed.<sup>1</sup>

Due to the change in law, which may have included a legislative error, all agreements with foreign C.A.A.’s were terminated by the I.R.S. effective January 1, 2017. At the same time, domestic C.A.A.’s were limited to assisting applicants that came to the U.S. Hence, I.T.I.N. applicants who resided outside the U.S. and were not in a position to provide official copies of identification documents were left without an option.<sup>2</sup>

By e-mail sent to foreign C.C.A.’s on April 17, 2017, the I.R.S. rescinded the termination of foreign C.A.A. agreements. From that point forward, foreign individuals may again file I.T.I.N. applications with foreign C.A.A.’s. A country-by-country list of foreign C.A.A.’s can be found on the I.R.S. website. At the same time, the I.R.S. introduced a new form effective April 17, 2017, requiring domestic C.A.A.’s to attest under penalty of perjury that an applicant was interviewed while in the U.S. (Form 15003, Attestation of Non-Resident Interviewed in the United States).

Although the rescission is welcome, its authority is unclear. The rule as amended by the P.A.T.H. Act (i.e., the legislation under which the issue arose) has not been changed.<sup>3</sup> Nonetheless, in an e-mail declaring Form 15003 obsolete as of May 3, 2017, the I.R.S. stated that U.S.-based C.A.A.’s were “allowed to continue to provide I.T.I.N. services to all applicants without additional form requirements.”

It is also to be noted that individuals who were issued I.T.I.N.’s before 2013 are required to renew their I.T.I.N.’s on a staggered schedule between 2017 and 2020.<sup>4</sup>

<sup>1</sup> 2015 P.A.T.H. Act 203(f)DivQ. See Beate Erwin et. al., “[Updates and Tidbits](#),” *Insights* 1 (2017).

<sup>2</sup> The authority of consular posts or missions in this respect varied from country to country.

<sup>3</sup> Code §6109(i).

<sup>4</sup> See in detail Galia Antebi et. al., “[Updates and Tidbits](#),” *Insights* 7 (2016).

## NEW FRENCH PRESIDENT: WHAT DOES IT MEAN FOR TAXATION?

The French presidential campaign focused on the economy with proposals to lower the national debt and encourage employment. The newly-elected president, Emmanuel Macron, seeks to boost French purchasing power and make the country more competitive in the global market by cutting taxes.<sup>5</sup> In light of the success of President Macron's party in the June elections, the proposals will likely be implemented.

### **Individual Tax Proposals**

#### **Wealth Tax**

In France, a wealth tax is due annually by individuals with net assets in excess of €1,300,000. Currently, the tax base includes all assets whatever their nature – with few exceptions such as professional assets or works of art. The new president proposes to reduce the tax base by only including real estate.

#### **Salaries**

It is proposed that the implementation of withholding tax on salaries and revenues will be delayed by one year and will apply beginning from January 1, 2019 (instead of January 1, 2018).

#### **Passive Incomes**

President Macron plans to streamline the tax regime for passive income from movable property by establishing a flat tax rate of 30% to replace the multitude of taxes which currently apply. For example, under French tax law, dividends received from domestic or foreign companies are included in the taxpayer's global taxable income. They are subject to the following taxes:

- Progressive rates of income tax up to 45%
- Social charges levied at 15.5%, of which 5.1% is tax deductible in the subsequent year
- An additional 3% tax for individuals earning between €250,000 and €500,000 per year increased to 4% on income above €500,000

#### **Dwelling Tax Exoneration**

During the presidential campaign, Mr. Macron proposed to exempt from the dwelling tax roughly 80% of taxpayers. Under current laws, the exemption was available only to taxpayers with low revenues such as retired people.

### **Corporate Tax Proposals**

#### **Corporate Income Tax**

French corporate income tax is generally imposed at the rate of 33.33%, and corporations that owe more than €763,000 in corporate income tax are subject to an additional 3.3% social charge on the amount of corporate income tax in excess of

*“President Macron plans to streamline the tax regime for passive income from movable property.”*

<sup>5</sup> [“Fiscalité et prélèvements obligatoires.”](#) En Marche!

€763,000. Corporations that have gross receipts below €7.63 million are subject to a reduced corporate income tax rate of 15% on taxable income up to €38,120.

President Macron has also announced that he intends to reduce the corporate income tax rate from 33.33% to 25%, which corresponds to the European average.<sup>6</sup>

## WILL THE U.S. IMPROVE F.A.T.C.A. RECIPROCITY OR JOIN THE C.R.S.?

The U.S. is facing increased pressure to exchange financial information after European politicians called on the European Commission to negotiate an accord making F.A.T.C.A. reciprocal. This latest move follows threats that the U.S. may be labeled a tax haven when the E.U. publishes its official “blacklist” (due to be finalized this year) and outcry from the European banking community.

Currently, the U.S. is not a participant in the Common Reporting Standard (“C.R.S.”), an offspring of F.A.T.C.A. developed by the O.E.C.D. and endorsed by the G-20 countries. Rather:

The United States has indicated that it is undertaking automatic information exchanges pursuant to FATCA from 2015 and has entered into intergovernmental agreements (IGAs) with other jurisdictions to do so. The Model 1A IGAs entered into by the United States acknowledge the need for the United States to achieve equivalent levels of reciprocal automatic information exchange with partner jurisdictions. They also include a political commitment to pursue the adoption of regulations and to advocate and support relevant legislation to achieve such equivalent levels of reciprocal automatic exchange.<sup>7</sup>

Under these I.G.A.’s, U.S. reciprocity with respect to the disclosure of financial information will be implemented on a long-term basis. E.U. banks have expressed fears that this timeframe will offer U.S. banks a competitive advantage as money-flows from the U.S. from the E.U. increase.

Furthermore, without reforms that increase reporting by U.S. financial institutions for non-U.S.-owned accounts, or U.S. participation in the C.R.S., foreign countries that have entered into reciprocal I.G.A.’s will not receive the same type of information as is provided to the U.S.

In light of U.S. concerns over data security and European demands for reciprocal, it is expected the U.S. will face strained negotiations with its counterparties.

## TRUMP’S TAX PLAN RELEASED

On Wednesday April 26, 2017, the Trump administration unveiled a one page tax

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<sup>6</sup> The Finance Law for 2017 already provides for a progressive reduction of the corporate income tax rate from the current 33.33% to 28% over the period 2017 to 2020.

<sup>7</sup> O.E.C.D., “[AEOL: Status of Commitments](#),” May 5, 2017.

plan designed to substantially cut U.S. tax rates and to simplify the tax code.

From an individual tax perspective, the current seven tax brackets would be reduced to three brackets – set at 10%, 25%, and 35%. Among other considerations, the President's plan would also double the standard deduction, repeal the alternative minimum tax, and eliminate most credits and deductions. Hence, a married couple will not pay any taxes on the first \$24,000 of income they earn. While the charitable tax deduction would remain, the tax deduction for state and local taxes would be eliminated. This would actually increase taxes for residents of high-tax states, such as New York and California.

One of the key measures is a reduction of the corporate tax rate from 35% to 15%, which is intended to encourage the repatriation of earnings held outside the U.S. The plan also calls for the U.S. to move to a territorial tax system that would limit taxation to domestic profits earned in the country.



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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.

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