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INSIGHTS

INDIA AND THE DIGITAL ECONOMY – THE EMERGING P.E. AND ATTRIBUTION ISSUES

2020 WILL MARK THE END OF AN ERA: SWISS CORPORATE TAX REFORM ACCEPTED

PEELING THE ONION TO ALLOCATE SUBPART F INCOME – THIS WILL MAKE YOU CRY!

AND MORE

Insights Vol. 6 No. 5

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About Us

EDITORS' NOTE

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

- **India and the Digital Economy – The Emerging P.E. and Attribution Issues.** The exponential expansion of information and communication technology has made it possible for businesses to be conducted in ways that did not exist 15 years ago. It has given rise to new business models that rely almost exclusively on digital and telecommunication networks, do not require physical presence, and derive substantial value from data collected and transmitted through digital networks. So how and where should these companies be taxed? Sunil Agarwal, an advocate and senior tax partner of AZB & Partners New Delhi, evaluates proposals already enacted in India and the U.K. and those under consideration at the level of the European Commission and E.U. member countries Italy, France, and Austria. Should the digital tax be a consumption tax passed on to the final consumer or a minimum income tax based on global profits or substantial economic presence? At this point, consensus does not exist.

- **2020 Will Mark the End of an Era: Swiss Corporate Tax Reform Accepted.** On May 19, 2019, Swiss Federal and Genevan cantonal voters accepted proposed corporate tax reforms by a large majority. As explained by Thierry Boitelle and Aliasghar Kanani of Bonnard Lawson Geneva, Switzerland will abolish its widely criticized cantonal special tax regimes and certain Federal regimes. At the same time, Switzerland and the cantons will introduce generally applicable reduced and attractive corporate income tax rates and several new special regimes, meeting current international standards and requirements. These changes will be effective as of 2020.

- **Reflections on My 66 Years in Public Accounting.** Periodically in life, one comes across an individual who is best described as follows: He or she "gets it." Difficult to describe analytically, in the tax world, the term means that (i) in solving technical problems, the person focuses on the material, leaving the immaterial to others; (ii) in making decisions, the person can separate the important from the unimportant; and (iii) in advising others on the impact of a new accounting rule or provision of tax law, the person can digest the complex and explain it in a series of simple sentences. Often, the individual is self-effacing. Arthur J. Radin was all of the above. He passed away in April. In his memory, we are pleased to republish an article written for the *CPA Journal* describing the way professional accounting changed during his 60-year career and, more importantly, the way the world changed. Arthur will be missed.

- **Proposed F.D.I.I. Regulations: Deductions, Sales, and Services.** The foreign derived intangible income ("F.D.I.I.") regime allows for a reduced rate of corporate tax rate on hypothetical intangible income used in a U.S. business to exploit foreign markets. Many implementation issues that were left open when the provision was enacted have been addressed in proposed I.R.S. proposed regulations issued early March. In their article, Fanny Karaman and Beate Erwin explain (i) which taxpayers benefit from the regime, (ii) the way deductions are taken into account, (iii) whether the deduction is always available when a U.S. corporation sells on a foreign market, (iv) the way in which foreign use of sales or services is established, and (v) the way in which related-party transactions can qualify as F.D.D.E.I. sales or services.

- **Peeling the Onion to Allocate Subpart F Income – This Will Make You Cry!** When Congress expanded the definition of a "U.S. Shareholder" in the T.C.J.A. by requiring the measurement of value as an alternative to voting power, it opened a Pandora's box of issues. First, more U.S. Persons became U.S. Shareholders. Second, it imposed a difficult task for shareholders and corporations to measure relative value of all classes of shares and all holdings of shareholders. Finally, many plans based on the existence of direct or direct or indirect dividend rights of foreign shareholders were shut down. Proposed regulations will modify the way Subpart F Income is allocated to various classes of shares having discretionary dividend rights. Neha Rastogi and Stanley C. Ruchelman explain the broadened scope of income inclusions under Subpart F.

- **Missed Opportunities – Tax Court Shows No Mercy for Indirect Partner.** In the U.S., there are several options to challenge an I.R.S. tax adjustment in the courts, including the U.S. District Court, the U.S. Court of Federal Claims, and the U.S. Tax Court. Of the three options, only a challenge in the Tax Court can be pursued without first paying the tax. Strict time limits are placed on filing a petition to the Tax Court. If a taxpayer misses the deadline, it must first pay the tax and then sue for refund in either of the other courts. The petition deadline is easy to determine when the I.R.S. proposes an adjustment to an individual or corporation, but when the adjustment is made to the income of a partnership – which yields tax exposure for partners – it is not always clear when the time limit has run out. In a recent memorandum decision, the Tax Court ruled that an indirect partner was not able to challenge the tax liability of a partnership because the petition came too late. In their review of the decision, Rusudan Shervashidze and Nina Krauthamer explain the strange facts involved and point out that the taxpayer did not have "clean hands."

- **Corporate Matters: Delaware Law Allows L.L.C. Divisions.** Delaware recently amended its company law to enable a limited liability company ("L.L.C.") to be divided into two or more newly-formed L.L.C.'s, with the original company either continuing or terminating its existence. The amendment provides L.L.C. members with significant flexibility in separating from each other so that assets, liabilities, rights, and duties of the company can be allocated among the resulting companies. Simon Prisk explains the change in company law.

- **New York State Renews the Three-Year Clawback for Gifts.** Generally, Federal estate and gift taxes are imposed on a person's right to transfer property to another person during life or upon death. State rules may differ from the Federal regime, imposing either an estate tax, inheritance tax, or gift tax or some combination of these taxes. New York State limits its taxation to an estate tax on the transfer of property at the time of death. There is no gift or inheritance tax. But, as of April 1, 2014, gifts made by a resident between April 1, 2014, and December 31, 2018, were clawed back into the taxable estate if the gifts were made within three years of death. The clawback has been extended to cover gifts made through December 31, 2025. Rusudan Shervashidze and Nina Krauthamer explain.

- **New York State Says No to Annual Pied-A-Terre Tax, Yes to Increased Real Estate Transfer Taxes.** As part of New York State's annual budget process, law makers proposed an annual *pied-à-terre* tax on homes worth $5 million or more that do not serve as the buyer's primary residence. At the last minute, the tax was dropped and replaced by a 0.25 percentage point increase to the real estate transfer tax on sellers and a new graduated mansion tax, a special transfer tax imposed on purchasers. Nina Krauthamer addresses the ins and outs of both taxes.

Enjoy the read.

- The Editors

INDIA AND THE DIGITAL ECONOMY – THE EMERGING P.E. AND ATTRIBUTION ISSUES[1]

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Tags
Digital Economy
India
P.E.

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BACKGROUND

Do you remember the first thing you ever bought or sold online? As we have been living with a digital economy for an entire generation, many of us would need to take a long stroll down memory lane in order to find the answer. In fact, it was just over 20 years ago in Ottawa in 1998, when the O.E.C.D., together with Canadian government, held the first international ministerial meeting on electronic commerce – what we now call the digital economy. It is worth recalling that, in 1998, Google was in its infancy and Facebook, YouTube, and Twitter were still a long way off. Many mobile phones still sported visible antennas and the price of internet access was steep. Truly, we have come a long way.[2]

Almost a century ago (in the era of League of Nations), value creation in a cross-border business was pictorially described as below:

> The oranges upon the trees in California are not acquired wealth until they are picked, not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reached fruition, may be shared in by different territorial authorities.[3]

The above paragraph highlights value creation in multiple jurisdictions and value realization in the market jurisdiction, which is typical of a transnational business carried on by a multinational enterprise (“M.N.E.”). Prior to the advent of digitalization, the M.N.E. could not do significant business in a market jurisdiction without having some kind of a physical presence there. This led to an allocation of taxing powers between the country of residence and the market jurisdiction based primarily upon the presence or absence of a tangible physical nexus, a so-called Permanent Establishment (“P.E.”), in the market jurisdiction.

More recently, the explosive growth and development of information and communication technology has enabled M.N.E.’s to sell goods and services in a market jurisdiction without the need for a traditional brick-and-mortar P.E., thereby avoiding payment of taxes to the jurisdiction where the M.N.E. derives a significant share of revenues.

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1 First published at the International Tax Conference organized by International Fiscal Association at New Delhi on April 26-27, 2019.

2 “Going Digital: Back to the Future,” *OECD Observer*, no. 317 (2019).

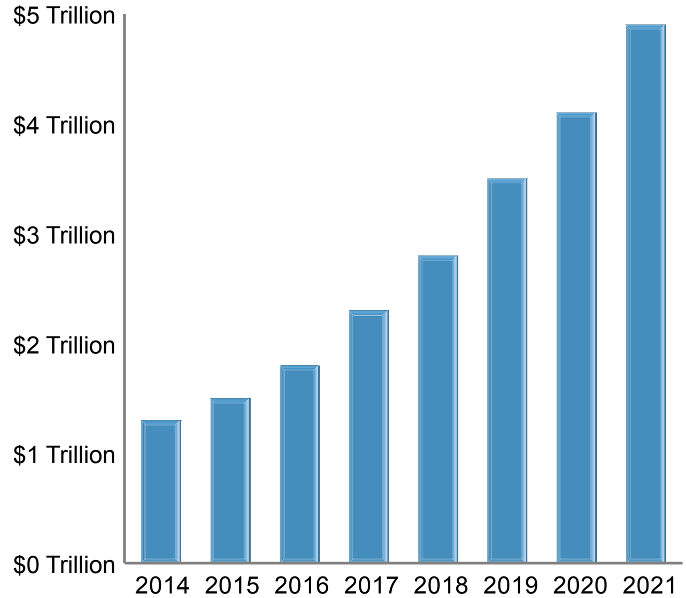
3 Excerpted in the Memorandum Explaining the Provisions in the Finance Bill, 2018.

EXPLOSIVE GROWTH OF INTERNET USERS[4]

Rank	Country	Internet Users (Millions)
1	China	746
2	India	699
3	USA	245
4	Brazil	123
5	Japan	117
6	Russia	110
7	Mexico	75
8	Germany	73
9	Indonesia	66
10	Pakistan	62
11	United Kingdom	62
12	Philippines	57
13	France	55
14	Nigeria	47
15	South Korea	47
16	Turkey	46
17	Vietnam	43
18	Iran	42
19	Egypt	37
20	Spain	37

[4] "List of Countries by Internet Users," Worldatlas, last updated January 15, 2019.

WORLDWIDE RETAIL E-COMMERCE SALES[5]



INDIAN RETAIL AND E-COMMERCE MARKETS[6]

Year	Total Retail Market	E-commerce Retail (out of total)
2017	$795 billion	$24 billion
2021 (projected)	$1200 billion	$84 billion

TAX ISSUES ARISING FROM EXPONENTIAL DIGITAL GROWTH[7]

The exponential expansion of information and communication technology has made it possible for businesses to conduct themselves in ways that did not exist earlier. It has given rise to new business models that rely almost exclusively on digital and telecommunication networks, do not require physical presence, and derive substantial value from data collected and transmitted through digital networks. These new business models have created new challenges for tax authorities around the world

5 "Global Retail E-commerce Sales 2014-2021," Statista.

6 "Indian E-commerce Market to Touch USD 84 Billion in 2021: Report," *The Economic Times*, February 26, 2019.

7 T. N. Pandey, "Income Taxation in Digital Economy," (presentation, Slideshare, July 4, 2017).

in terms of nexus, characterization, and valuation of data and user contribution. These challenges are recognized by the international community and have been formally addressed by the G-20 and O.E.C.D. under B.E.P.S. Action 1.

The ambiguities surrounding the taxation of income from the digital economy and the resulting tax disputes are not only a bane for tax authorities. They also place constraints on taxpayers, who may be subject to inconsistent approaches on the part tax authorities – a situation that, at best, should be avoidable.

POPULAR DIGITAL BUSINESS MODELS

The O.E.C.D. report on B.E.P.S. Action 1 lists some of the more prevalent forms of digital businesses in paragraphs 118 to 121:

> **4.2.1.1 Business-to-business models**
>
> 118. The vast majority of e-commerce consists of transactions in which a business sells products or services to another business (so-called business-to-business (B2B)) (OECD, 2011). This can include online versions of traditional transactions in which a wholesaler purchases consignments of goods online, which it then sells to consumers from retail outlets. It can also include the provision of goods or services to support other businesses, including, among others: (i) logistics services such as transportation, warehousing, and distribution; (ii) application service providers offering deployment, hosting, and management of packaged software from a central facility; (iii) outsourcing of support functions for e-commerce, such as web-hosting, security, and customer care solutions; (iv) auction solutions services for the operation and maintenance of real-time auctions via the Internet; (v) content management services, for the facilitation of website content, management and delivery; and (vi) web-based commerce enablers that provide automated online purchasing capabilities.[8]
>
> **4.2.1.2 Business-to-consumer models**
>
> 119. Business-to-consumer (B2C) models were among the earliest forms of e-commerce. A business following a B2C business model sells goods or services to individuals acting outside the scope of their profession. B2C models fall into several categories, including, for example, so-called "pureplay" online vendors with no physical stores or offline presence, "click-and-mortar" businesses that supplemented existing consumer-facing business with online sales, and manufacturers that use online business to allow customers to order and customize directly.[9]
>
> 120. The goods or services sold by a B2C business can be tangible (such as a CD of music) or intangible (*i.e.* received by consumers in an electronic format). Through digitization of information, including

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[8] *Id.*, para 4.2.1.1.

[9] *Id.*, para 4.2.1.2.

text, sound, and visual images, an increasing number of goods and services can be delivered digitally to customers increasingly remote from the location of the seller. B2C e-commerce can in many cases dramatically shorten supply chains by eliminating the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods. Partly because of this disintermediation, B2C businesses typically involve high investment in advertising and customer care, as well as in logistics. B2C reduces transaction costs (particularly search costs) by increasing consumer access to information. It also reduces market entry barriers, as the cost of maintaining a website is generally cheaper than installing a traditional brick-and-mortar retail shop.[10]

4.2.1.3 Consumer-to-consumer model

121. Consumer-to-consumer (C2C) transactions are becoming more and more common. Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions. These businesses may or may not charge the consumer for these services, depending on their revenue model. This type of e-commerce comes in several forms, including, but not limited to: (i) auctions facilitated at a portal that allows online bidding on the items being sold; (ii) peer-to-peer systems allowing sharing of files between users; and (iii) classified ads portals providing an interactive, online marketplace allowing negotiation between buyers and sellers."[11]

CHARACTERISTICS OF THE DIGITAL ECONOMY

Digitalized business models have the following three characteristics:

- Scale without mass
- Heavy reliance on intangible assets
- Data & user participation

DISTORTIONS CAUSED BY THE DIGITAL ECONOMY

The most demonstrable distortion caused by digital businesses is horizontal inequity, whereby a nonresident enterprise selling goods and services in a jurisdiction does not pay taxes on the income earned from sales in that jurisdiction because of the absence of P.E., while at the same time a domestic enterprise engaged in similar business activities in the same jurisdiction would have to pay tax.

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10 *Id.*

11 *Id.*, para 4.2.1.3.

If this distortion is not addressed in a timely manner, this may lead to obvious undesirable economic effects in the economy of source jurisdiction, and consequently impede the transnational flow of goods, services, capital, and personnel.

OVERARCHING PRINCIPLES OF TAX POLICY

The following well-established principles of tax policy must be kept in mind when addressing the distortions caused by the digital economy:

- **Equity:** Taxpayers in similar circumstances should bear a similar tax burden.
- **Neutrality:** Economic choices available for carrying on businesses should be tax-neutral.
- **Efficiency:** Minimal compliance costs should apply to the taxpayer, as well minimal administration costs for governments.
- **Certainty and Simplicity:** Tax rules should be simple and easy to understand for the taxpayers.
- **Effectiveness and Fairness:** Taxation should produce the right amount of tax at the right time, avoiding either double taxation or double non-taxation.
- **Flexibility:** Taxation systems and policies should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments.

O.E.C.D. PROPOSED SOLUTIONS[12]

During the course of deliberations on Action 1 of the B.E.P.S. Project, the O.E.C.D. recommended a two-pronged approach:

> There should be a significant salutary impact of other BEPS measures on BEPS concerns caused by Digital Economy, namely:
>
> - Changes suggested by BEPS Action 7 which could control artificial avoidance of PE status
> - Changes suggested by BEPS Action 8-10 strengthening transfer pricing rules

Pending an evaluation of the impact of other measures on the base eroding effects of the digital economy, the O.E.C.D. considered various options but stopped short of adopting any O.E.C.D. recommended standard. Rather, it left it to countries to consider whether to adopt any of the proposed options, either alone or in conjunction with other approaches, subject to countries having regard to existing treaty obligations.

The table in the following section evaluates the fundamental characteristics of the three options proposed by the O.E.C.D.

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[12] O.E.C.D., "Tax Challenges of Digitalisation: Comments Received on the Request for Input – Part II," October 25, 2017.

THREE APPROACHES TO TAXING THE DIGITAL ECONOMY[13]

	Option 1: Significant Economic Presence ("S.E.P.")	Option 2: Equalization Levy	Option 3: Withholding Tax
Type of Tax	Net income tax on M.N.E.'s	Tax on final consumption	Tax on final consumption
Tax Base	Net business income (gross receipts minus costs)	Gross receipts on sales to customers	Gross receipts on sales to customers
Geographic Concept	Residence (where firm is headquartered) and/or Source (where economic activity is located)	Destination (where customer is located)	Destination (where customer is located)
Scope of Tax	Applies to • income earned within the taxing country or • worldwide income	Limited to final consumer purchases	Limited to final consumer purchases

"Some countries have decided to impose a withholding tax on the gross amount of revenue derived by an M.N.E. from the source jurisdiction, while others have opted for an equalization levy."

THE CURRENT SITUATION

In view of the hands-off, wait-and-watch approach adopted by O.E.C.D., some countries have decided to impose a withholding tax on the gross amount of revenue derived by an M.N.E. from the source jurisdiction, while others have opted for an equalization levy.

Some details are outlined below:

- India imposes a 6% Equalization Levy on specified base-eroding digital businesses. This levy has been kept out of the tax treaty network, hence there are issues on the ability of the affected nonresident to receive a foreign tax credit for taxes withheld in India.[14]
- The E.U. recommended 3%. However, some countries in E.U. have opposed this levy, namely Ireland, Sweden, Denmark, and Germany.
- The U.S. has opposed the imposition of a digital tax, as it would have significant effect on the foreign tax exposure of the U.S. tech giants, like Facebook, Google, and Amazon, by forcing them to pay taxes in the countries where

13 *Id.*

14 *Id.*

they do business, instead of in low-tax jurisdictions like Ireland or Luxembourg. It also will raise no tax in the U.S.

- The U.K. introduced a Digital Services Tax in 2017, and Austria, France, and Italy are proposing unilateral digital services taxes as well.[15]
- Bangladesh has also imposed a V.A.T. on digital businesses.

It is evident that these measures are unilateral and uncoordinated among countries. By their very nature, they are *ad hoc*, inconsistent, and lacking clarity, which will lead to the imposition of a disproportionate tax burden on M.N.E.'s operating in multiple tax jurisdictions.

Such measures cannot provide a lasting solution to the problem.

POSSIBLE FEATURES OF S.E.P.-BASED ECONOMIC NEXUS[16]

The new P.E. nexus may consist of the following elements:

- Specified sale and service transactions carried out digitally
- User threshold
- *De minimis* revenue threshold

For this purpose, a new Article 5(8) may be introduced in the O.E.C.D. Model Tax Convention (Article 5(9) in the United Nations Model) with the following suggested wording:

> If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.

The advantage of this method is that the allocation of taxing powers can be implemented in line with the arm's length principle or through a combination of the arm's length principle and formulary apportionment.

As regards the former scenario, it may be necessary to amend the current O.E.C.D. Transfer Pricing Guidelines in order to allocate income between an enterprise and its P.E. based on digital presence.

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15 See "Austria, France, and Italy to Introduce Digital Services Taxes," *Insights* 6, no. 4 (2019).

16 See Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," (working paper, IBFD, 2015).

DUAL APPROACH: WITHHOLDING TAX PLUS OPTIONAL S.E.P.-BASED NET TAXATION[17]

This option considers both installing a withholding tax mechanism as the primary response to these challenges and using withholding taxes in support of a S.E.P.-nexus based solution.

A nexus-based solution should prove superior to the withholding tax solution since it is consistent with the O.E.C.D.'s approach to the matter; it is likely to be more efficient (*i.e.*, less wasteful); and it would likely be easier to fine-tune in order to reach a stable balance between taxation in the market and residence jurisdictions.

Consequently, a practical way could be to impose a global consensus-based standard X%[18] final withholding tax on all base-eroding business payments to registered nonresidents, with specific, again global, consensus-based exemptions to payees registered to be taxed in the market jurisdiction under a net taxation scheme. Such net taxation scheme may be a nexus-based solution or an elective scheme to avoid the withholding tax proposed here.

This proposal depends on a reliable, global consensus-based standard, quick, cheap, and automatically-shared registration system shared by at least the major economies actively participating in the B.E.P.S. Project spearheaded by G-20 and O.E.C.D. countries.

Payments to unregistered payees would be subject to a higher percentage of withholding tax as compared to nonresidents covered in the previous paragraph. These would include payments to accounts in or owned by low- or no-tax jurisdictions (*e.g.*, corporate tax at or below 15%). This tax may be non-final and partially refundable upon filing.

> ***"A nexus-based solution should prove superior to the withholding tax solution."***

B2C transactions would initially be exempt as non-base-eroding. Yet, if countries are already concerned with the revenue division implications of such a decision, a complimentary final withholding tax of X%[19] could be collected on all payments cleared by financial institutions, unless the payees register to be taxed under any net taxation scheme.

The withholding tax scheme is not perfect. However, in the event that countries cannot reach agreement on a nexus-based scheme, it permits a simple, if crude, response to the challenges of the digital economy. As such, however, it requires monitoring and perhaps tweaking over time based on experience gained. Therefore, the scheme should be accompanied by a review mechanism.

In addition, the multilateral instrument (Action 15) may be used for efficient standardization of the solution. Advances in reporting (*e.g.*, Country-by-Country ("CbC") Reporting) and automatic information exchange, as well as all monitoring aspects (Actions 11-13) also fit well with the necessary review mechanism.

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17 See Yariv Brauner and Prof Andres Baez, "Withholding Taxes in the Service of B.E.P.S. Action 1: Address the Tax Challenges of the Digital Economy," (working paper, IBFD, 2015).

18 This is a conscious departure from the working paper by Brauner and Baez.

19 *Id.*

LONG-TERM PERSPECTIVE

In the long term, it appears that net basis taxation using S.E.P. as a nexus, in addition to the traditional brick and mortar P.E. concept, may be the most effective approach to address the taxation of the digital economy.

Basis of S.E.P.-Based P.E. Threshold

The nexus should be uniform globally. As an example, gross revenues from digital businesses derived by an M.N.E. from purchasers in one jurisdiction amounting to, say, $X million or an equivalent amount in local currency in a tax year. In other words, this basis would not work if every country were to decide its own threshold. A cue can be taken from the €750 million CbC Reporting threshold on transfer pricing matters under B.E.P.S. Action 13.

S.E.P.-Based P.E. Income Computation

Net income from the S.E.P.-based P.E. could be computed either on an attribution basis under the arms' length principle or using formulary apportionment, or a mix of the two. It should be noted that the O.E.C.D. has always preferred attribution over formulary apportionment. However, one cannot forget the old adage that "necessity is the mother of invention." Unique problems do call for unique solutions. There are obvious constraints in applying the attribution principle. In a digital business, it is likely that most of functions, assets, and even some of the major risks will not be located in the market jurisdiction. Only sales, revenue realization, and post-sale warranty obligations will happen there. Under these circumstances, it is anybody's guess how effective it will be to apply the arm's length principle.

However, if a global consensus on the attribution basis is achieved, it will be further desirable to apply all principles applicable to computation of business income as contained in Article 7 of double tax treaties, as far as possible, since the S.E.P.-based P.E. will also be a P.E. on par with a traditional brick and mortar P.E. In particular, a deduction should be allowed for business expenses of the S.E.P.-based P.E., including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred, whether in the market country or elsewhere.

ROLE OF THE MULTILATERAL INSTRUMENT

Since the S.E.P.-based P.E. will require an amendment to existing double tax treaties, the proposal suggested herein can be efficiently achieved only through the multilateral instrument already existing in terms of B.E.P.S. Action 15.

2020 WILL MARK THE END OF AN ERA: SWISS CORPORATE TAX REFORM ACCEPTED

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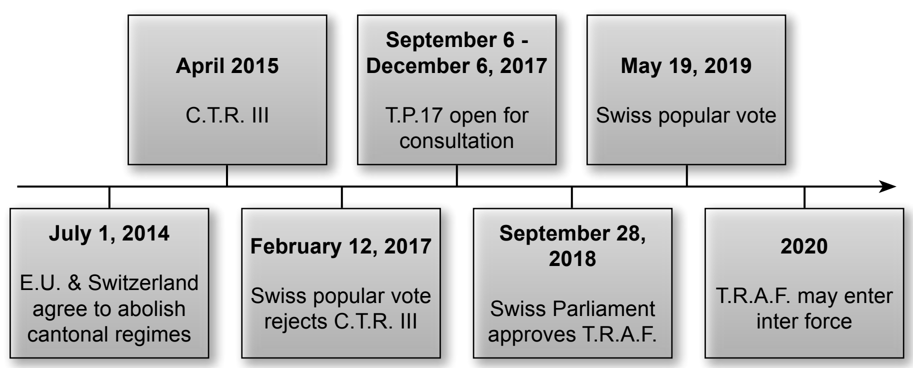
INTRODUCTION

On May 19, 2019, Swiss Federal and Genevan cantonal voters accepted the 2020 Swiss Federal and Genevan cantonal corporate tax reforms by a large majority. As explained below in detail, as of 2020, Switzerland will, on one hand, abolish its widely criticized cantonal special tax regimes and certain Federal regimes. On the other hand, Switzerland and the cantons will introduce generally applicable reduced and attractive corporate income tax rates as well as several new special regimes, meeting current international standards and requirements. In sum, Switzerland is expected to remain attractive for existing and new corporate ventures.

CHANGES TO THE SWISS AND GENEVAN CORPORATE TAX SYSTEMS AS OF 2020

Timeline



In response to international criticism and strong pressure from the E.U. and the O.E.C.D., the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F.") abolishes the current corporate tax privileges for (i) base, auxiliary, domicile, and mixed companies; (ii) holding companies; (iii) finance branches; and (iv) principal companies as of December 31, 2019.

At the Federal level, the Swiss Parliament previously accepted the law on June 14, 2016, as the so-called 3rd Corporate Tax Reform ("C.T.R. III"). However, the Swiss electorate rejected the C.T.R. III by referendum in February 2017. The general view was that C.T.R. III provided benefits for large corporations without benefitting ordinary individuals. The Swiss Federal Council originally intended to solve this issue by increasing family allowances. However, since this measure would not have benefited the entire population by any stretch, Parliament instead decided in favor of linking corporate tax reform with supplementary financing for A.H.V. (*i.e.*, the first pillar of old age pension insurance).

In the spring of 2018, the T.R.A.F. proposal was introduced in Parliament. It was subsequently adopted there in a final vote on September 28, 2018. Finally, on May 19, 2019, the Swiss voters accepted T.R.A.F. by a large two-thirds majority. The reform can now enter into force on January 1, 2020.

At the cantonal level, the Geneva State Council adopted the draft law to implement T.R.A.F. on October 17, 2018. On December 11, 2018, the tax commission of the Genevan Parliament approved the cantonal draft law, which was accepted by voters on May 19, 2019.

As a result, the following measures are introduced as of 2020:

- **Tax Privileges:** As previously mentioned, T.R.A.F. abolishes the current corporate tax privileges for (i) base, auxiliary, domicile, and mixed companies; (ii) holding companies; (iii) finance branches; and (iv) principal companies as of December 31, 2019. In this context, please note that the Swiss Federal Tax Administration ("F.T.A.") no longer applies the practices of principal companies and Swiss finance branches to new companies beginning in 2019.

- **Effective Corporate Income Tax Rates:** The cantons have the option to reduce the effective cantonal corporate income tax rate. Each canton should decide which rate should be applicable.

  As of 2020, the canton of Geneva will provide an effective general cantonal corporate income tax rate of 13.99%, with an absolute minimum of 13.48%.

  Ahead of this, the canton of Vaud already reduced its corporate income tax rate from 23.5% (Lausanne) to 13.79% beginning in 2019 and approved by popular vote on March 20, 2016, with an astonishing majority of 87%.

- **Capital Tax for Companies:** T.R.A.F. allows cantons to introduce reduced capital tax rates for qualifying participations, patent box assets, and intra-group loans. Cantons were already allowed to credit the corporate income tax against the capital tax.

  As of 2020, the canton of Geneva will provide (i) a special reduced capital rate of 0.0012% for the above-mentioned qualifying assets and (ii) a progressive credit of corporate income tax against capital tax. As of the tax year 2024, 100% of the corporate income tax will be available for credit against the capital tax. In other words, no capital tax will be due as long as sufficient profits are maintained.

  Today, the canton of Vaud already provides for a full credit of corporate income tax against capital tax.

- **Patent Box:** As of January 1, 2020, a patent box will be introduced at the cantonal tax level to provide privileged taxation on income from patents and similar intellectual property ("I.P.") rights. The tax privilege will consist of an exemption from cantonal tax on up to 90% of qualifying I.P. income. The cantons are free to apply a lower exemption.

The O.E.C.D.'s nexus approach for I.P. regimes will be applied in the sense that I.P. income will qualify for benefits only to the extent that the taxpayer demonstrates the income results from R&D expenses that it has incurred in developing the I.P. This means that income derived from acquired I.P. will not qualify for the patent box exemption.

Individual enterprises ("Independents") will also be able to benefit from the new Swiss patent box regime.

The canton of Geneva will also introduce the new O.E.C.D.-compliant restricted patent box, but the cantonal reform provides that qualifying income from patents would benefit only from a reduction of up to 10%.

- **Cantonal Research & Development ("R&D") Incentives:** With the aim to promote Swiss-based R&D activities, the cantons are given the option to apply a super-deduction for Swiss R&D expenses up to a maximum of 150% of qualifying expenditures. The cantons are free to enact the new R&D tax incentives from January 1, 2020. If adopted, incentives will also apply to Independents. As of January 1, 2020, the canton of Geneva will introduce a super-deduction of 150% for Swiss R&D expenses.

- **Notional Interest Deduction ("N.I.D."):** As of 2020, T.R.A.F. will allow cantons to introduce an N.I.D., provided the effective overall corporate income tax rate in the capital city of the canton is at least 18.03%. Based on current legislation and proposals, it is expected that this will be the case only in the canton of Zurich, which plans to adopt an effective rate of 18.2%.

- **Hidden Reserves:** Hidden reserves and goodwill that were created when a company was abroad, or that relate to the relocation of assets or functions to Switzerland, can be capitalized (stepped-up) in the tax balance sheet without immediate taxation. Similarly, such hidden reserves and goodwill will be taxed immediately if the company, its assets, or its functions leave Switzerland or are otherwise no longer subject to Swiss tax (*e.g.*, in the case of liquidation).

  For newly arriving companies, the step-up remains tax-free and the hidden reserves can subsequently be amortized in the following years (*e.g.*, goodwill depreciation over ten years), resulting in substantial tax reductions. For existing Swiss-resident companies currently enjoying a cantonal tax privilege, the hidden reserves must be determined by way of a special assessment by the cantonal tax authorities at the time T.R.A.F. enters into force on January 1, 2020. At that time, hidden reserves will be separately taxed at reduced rates if and to the extent they are realized within a five-year transition period following the entry into force of T.R.A.F., *i.e.*, the tax day of tax year 2024. Geneva provides for a special reduced rate of 13% applicable to the above-mentioned hidden reserves.

- **Dividend Taxation:** The tax on dividend distributions to individual substantial shareholders (10% or more ownership) is increased to 70% of the tax base at the Federal level and a minimum of 50% of tax base at the cantonal level as determined by the cantons and using financing and compensation in connection with the measure. The reform accepted in Geneva provides for a base of 70% for private assets and 60% for business assets.

- **A.H.V.:** T.R.A.F. includes supplementary financing of around CHF 2.0 billion for A.H.V. – CHF 1.2 billion due to the increase in salary contributions (0.3%) and CHF 0.8 billion due to the increase in the Federal A.H.V. contribution and waiver of the Confederation's share of the percentage point of V.A.T. earmarked for demographic change.

- **Transpositions:** Anti-abuse provisions in the law treat a transposition as a taxable private capital gain by exception. Ordinarily, private capital gains are exempt from tax in Switzerland. "Transposition" is the term used for a sale to one's self. It occurs when an individual sells participation rights to a company in which he or she holds a controlling stake, which is at least 50%. The current statutory regulations provided for a *de minimis* rule under which tax is imposed only when at seller transfers at an interest of at least 5%. Apparently, major repetitive transfers were effected on interests below the 5% threshold. Parliament perceived that the *de minimis* transfer rule was prone to abuse. Consequently, the threshold has been abolished under T.R.A.F. as of 2020. At that point, the gain on a transposition will be taxed.

- **Capital Contributions:** As of 2020, Swiss listed companies must also distribute a taxable one-franc dividend for each franc distributed free of tax because they are paid from the capital contribution reserve. This will result in additional receipts for the Confederation, cantons, and communes. In Parliament, these additional receipts were estimated at CHF 150 million. Certain exceptions apply to restructurings and to foreign companies moving to Switzerland.

CONCLUSION

Approval of T.R.A.F. marks the end of an almost 14-year tax dispute between Switzerland and the E.U. As of 2020, Switzerland will generally provide attractively low corporate income tax rates to all economic actors, whether Swiss or foreign, while at the same time introducing some new special tax regimes that are fully compliant with today's strict international standards and requirements.

REFLECTIONS ON MY 66 YEARS IN PUBLIC ACCOUNTING[1]

Author
Arthur J. Radin

Tags
Accounting
Audit
Tax Returns

My initiation to the accounting profession came in 1951, when I was first old enough to get working papers. In my time off from school, I went to work for my father, a C.P.A. who was certified around 1925. I had such important functions as filing, copying documents, proofreading and collating reports, backing up the switchboard operator, and running messages.

After college, because I had not completed enough courses to take the C.P.A. exam and had not been in the army, I could not get a job with a major firm. (I kept all 63 rejection letters for 20 years.) A one-owner, three-staff firm did finally hire me; on my first assignment, I was told I would be working on a "statement" account. I thought I was to prepare financial statements; in fact, it meant I was to write up the 30 or 40 individual customer statements each month.

In January 1960, having obtained my M.B.A. and spent six months in the army, I returned to New York City, newly married and unemployed. My first stop was Touche, Niven, Bailey, and Smart (now Deloitte Touche Tohmatsu), where the personnel manager had liked me on my previous visit. I was hired on the spot for $525 a month. My wife and I wondered how we would ever spend so much money.

Eighteen years later, I elected for various reasons to return to a small company atmosphere, where I remain to the present day. In all, I have been with five firms, aside from my dad's office. Many things have changed. Some have not.

In Memoriam:

Arthur J. Radin, C.P.A., was a partner emeritus at Janover LLC, New York, N.Y., and a member of The CPA Journal Editorial Advisory Board. Arthur passed away in April 2019. He had a bright mind and a wonderful sense of the absurd. These qualities made him an excellent accountant, as they enabled him to understand the world as it is. He will be missed.

A CHANGING WORKPLACE

Back then, everything was handwritten, so good handwriting was essential. Reports were typed on manual typewriters. Accountants had to learn to add a column of numbers; I was not allowed to use an adding machine.

As there were no copy machines, carbon paper was used to create multiple copies. Negatives had to be in red, and typewriter ribbons had both a black and a red section. If there was a negative, we had to insert red copy paper. Everyone's hands were dirty; typos were a nightmare, accurate typing skills were essential. I couldn't thank my mother enough for insisting that I take typing in 11th grade, a skill that still serves me well in the computer age. Tax return preparation on the computer is wonderful, ensuring that we do not make obvious calculation errors, and it's nice that the I.R.S. no longer writes us that we added something wrong.

Office buildings at the time were hot in the summer – no air conditioning, only an open window. The dress code was suits and ties every day. For one large Touche

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[1] This article was originally published in the September 2018 Issue of *The CPA Journal* and is reproduced here with the journal's permission.

client, I had to wear a hat. I dutifully bought one from a friend's parents' haberdasher and wore it for a few weeks; after that, it collected dust.

In the firms, most of the accountants were men and most of the secretaries were women. Everyone dated, and there were lots of marriages. The demographics of the profession has changed for the better. When I started, it was almost all white men. Now we have many female accountants, and the office looks like the United Nations. I love it.

"The client needs attention, wants to feel loved. Some of the best advice I ever received was that accountants lose clients when the client perceives that their accountant is indifferent."

CHANGES IN THE CULTURE

One of the old concepts – client service – still prevails. The client needs attention, wants to feel loved. Some of the best advice I ever received was that accountants lose clients when the client perceives that their accountant is indifferent. In my youth, auditors loved to go to the client; staying at the office was a drag. All the information we needed was at the client, and more importantly, we met new people and learned how businesses worked. I was taught about the T.A.L.L. approach to practice development – Take A Lawyer (or client) to Lunch. This paid off; over the years, I brought in many clients.

These days, both my staff and my partners want to keep to the office. They're happy staying in, emailing the client the information needed for the audit, receiving it by email, entering it into our audit software, making selections, and receiving the selections by email. They're proud that the whole business can be done while never once visiting the client. It's very efficient – and very boring.

CHANGES IN PRACTICE AND PROCEDURE

When I started at Touche, I was suddenly an "auditor," although in the beginning I did not understand what that meant. (Yes, I took auditing in graduate school and received an A, but I never grasped that the purpose of auditing was to issue an opinion on the financial statements.) I have come to love auditing, although it used to be more fun. I used to claim that it took 20 years to become a good tax specialist, ten years to become a good G.A.A.P. accountant, and three years to become a good auditor. Auditing used to be all common sense; now it has become highly technical and not at all intuitive. The standards now run well over 1,000 pages of small print and, although they have been "clarified," I find it very difficult to get answers to my issues.[2] With all the checklists, evaluations of assertions, and required correspondence with clients, no one seems to have time to understand the clients or their businesses, or enjoy what they are doing.

The concept of "up-or-out" – either get promoted in a reasonable time or find another job – did not exist until around 1965, when the large firms started to adopt the policy. Eight years after starting at Touche and after many rapid promotions, I was made a partner at the age of 31. I did not think I was too young to be a partner; others did. (Today, 40 years after I left the firm, I am amazed how often someone introducing me says, "He was a partner of Deloitte," to establish my credentials.)

Early in my career there, I started working on clients who were registered with something called the Securities and Exchange Commission ("S.E.C."). I had to figure out for myself what this agency was and why it could tell my clients what to do.

My work on S.E.C. clients continued for the next 54 years, comprising some of my most interesting accounting and auditing experiences. Working on S.E.C. filings, including annual reports and new issue registrations as well as occasional testimony, was always fascinating and frequently nerve-racking.

Over the years, the profession became more disciplined. Accounting and auditing standards changed from suggestions to mandates. Generally accepted accounting standards went from a half-inch book to four books totaling eight inches. Notes have grown uncontrollably.

Back then, accounting standards were written by an unpaid group of accountants, the Accounting Principles Board. I loved having a Touche partner, Don Bevis, on the board. Clients could meet with Don and discuss the proposed standards. After they were adopted, we could receive instruction from someone who helped draft the standard. And just as wonderful, if I did not like the final standard, I had someone to complain to.

No one does bookkeeping anymore. It all seems handled by a computer using a program such as QuickBooks. I believe there's an advantage to having done bookkeeping, as the equation of the debits having to equal the credits becomes second nature. I find I occasionally have to plot out debits and credits for my staff.

Required Continuing Professional Education ("C.P.E.") did not exist in the old days. Despite the lack of C.P.E., we all managed to learn on the job. In fact, a best

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[2] See "Have Audits Become Too Inefficient and Expensive?" *The CPA Journal*, February 2016.

practice that remains unchanged in 66 years is the willingness of more experienced professionals to train less experienced staff. You still learn mostly by asking the person next to you.

Tax research seems to be much changed. I preferred the wonderful old CCH binders with the Internal Revenue Code, Treasury Regulations, and explanations; it was easier to handle than the modern computer references and search engines.

THE BENEFITS OF A SMALLER PRACTICE

After 18 years with Touche, two developments made my staying at the big firm for my entire career seem unlikely.

First, the requirement for rotation of audit partners on S.E.C. engagements resulted in my losing the business relationships I had built up. I started working with Macy's as a junior accountant, working myself up over 15 years to be partner in charge of the audit. Suddenly, I was being told that I had to give up the client, and if I was nice, management would give me another client. Personal relationships ended as the client's personnel had to deal with another partner. The human satisfaction of having done a good job over many years disappeared. (Incidentally, that satisfaction stays in the audit department of firms not requiring rotation.)

"In the end, I have no complaints. I am pleased with my choice of profession and recommend it strongly. I am proud of my profession for training our country's accounting and finance practitioners."

Second, being a partner in the "Big Eight" was high pressure. Retirement was required at age 62, but it sure seemed like many partners had heart attacks before then. On the other hand, I kept meeting partners of small firms who were in their 80s, including my father.

My years at Touche were wonderful, but as the firm grew, I began to feel that I really needed to work in a smaller environment. In addition, I had married a member of the audit staff, and since there was a "no nepotism" rule, one of us had to leave. I lunched with some friends who had a small C.P.A. firm; by the end of the lunch, I was joining them. My wife stayed at Touche.

My former partners were horrified. "What about your pension?" I said that if I was worried about my pension at 40, I was in deep trouble. "You're too dependent on a large client." In fact, I found that in many ways I became more independent. The loss of Macy's would have been a major disaster to Touche, while the loss of any client to a small firm is more easily handled.

Our new firm grew and prospered. In 1998, I again felt that I wanted a smaller firm and left with two of my partners. After 18 very successful years with three or four partners, we ran into the usual continuity issues and on January 1, 2015, we joined Janover L.L.C., where I will complete my career. While the firm is not mine, the partners are delightful to work with and very professional.

In the end, I have no complaints. I am pleased with my choice of profession and recommend it strongly. I am proud of my profession for training our country's accounting and finance practitioners. Lawyers always refer to the law school they attended; accountants refer to the firm they started with.

I have made a good living all these years. I was able to pay for all my children to go to college. My retirement is funded. All those lawyers I had lunch with all those years are still, mostly, available for lunch. I met my wife through accounting. I still deal with my clients, although all have been assigned to another Janover partner who handles the accounting and tax matters, sometimes not as well as I did but sometimes better.

And I remember a refrain of the saying we used while hunched over our workpapers: Old accountants never die; they just fade away.

PROPOSED F.D.I.I. REGULATIONS: DEDUCTIONS, SALES, AND SERVICES

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Tags
F.D.I.I.
Tax Reform
T.C.J.A.

On December 22, 2017, the Tax Cuts and Jobs Act 2017 ("T.C.J.A.")[1] introduced the foreign derived intangible income ("F.D.I.I.") regime into the Code. This tax favorable regime is limited to entities taxed as U.S. corporations.

In essence, F.D.I.I. constitutes a taxable U.S. corporation's income from specified export activities. More precisely, the F.D.I.I. regime allows for a reduced corporate tax on hypothetical intangible income used in a U.S. business in exploiting foreign markets. Under the F.D.I.I. rules, the hypothetical intangible income is reduced by a 37.5% deduction, which is intended to result in an effective Federal corporate income tax rate of 13.125% for a U.S. corporation.[2] It is important to note that, due to the way F.D.I.I. is computed, the effective rate on export income is generally higher than 13.125% under this rule.

On March 6, the I.R.S. published comprehensive proposed regulations addressing F.D.I.I.[3] They contain a substantial number of examples. If adopted in final version, the proposed regulations would be applicable to taxable years ending on or after March 4, 2019.[4]

THE F.D.I.I. COMPUTATION – A BRIEF RECAP

To determine its F.D.I.I. deduction, a domestic corporation must first determine its F.D.I.I. amount.

This determination is made through a multistep process that involves the following calculations:

1. Deduction eligible income ("D.E.I.")
2. Foreign derived deduction eligible income ("F.D.D.E.I.")
3. Qualified business asset investment ("Q.B.A.I.")
4. Deemed intangible Income ("D.I.I.")[5]
5. F.D.I.I.

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1 Public Law 115-97.

2 For tax years beginning after December 31, 2025, the allowable deduction is decreased, and the effective tax rate will be 16.406% (Code §250(a)(3)(A)).

3 I.R.S.; Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income, 84 Fed. Reg. 8188 (March 6, 2019).

4 Prop. Treas. Reg. §1.250-1(b).

5 See in detail, "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?" *Insights* 5, no. 1 (2018), Components of the F.D.I.I. Provision.

The formula to determine F.D.I.I. can best be summarized by the following equations:

F.D.I.I. Equation
F.D.I.I. = D.I.I. * (F.D.D.E.I. / D.E.I.) [6]

D.I.I. Equation
D.I.I. = D.E.I. – (Q.B.A.I. * 10%)

A key concept under F.D.I.I. is the computation of a U.S. corporation's hypothetical intangible income, known as D.E.I. The computation of D.E.I. begins with the gross income of the domestic corporation, from which the following income items are removed:

- Subpart F Income derived from controlled foreign corporations ("C.F.C.'s") and included in taxable income under Code §951(a)(1)
- Amounts of global derived intangible income ("G.I.L.T.I.") derived from C.F.C.'s and included in taxable income under Code §951A
- Financial services income of the corporation – typically limited to financial institutions
- Any dividend received from a C.F.C.[7]
- Domestic oil and gas extraction income of the corporation
- Foreign branch income[8]

D.E.I. is then reduced by a deemed 10% return on the corporation's Q.B.A.I.[9] Q.B.A.I. is measured by reference to the U.S. corporation's average aggregate adjusted bases in depreciable tangible property used in the production of D.E.I. The result is then prorated in the ratio export-related D.E.I. (*i.e.*, F.D.D.E.I.) bears to total D.E.I.

For purposes of the computation, F.D.D.E.I. is D.E.I. derived in connection with (i) property sold to a non-U.S. person for non-U.S. use ("F.D.D.E.I. Sales") and (ii) services provided by the taxpayer to persons, or with respect to property, located outside the U.S. ("F.D.D.E.I. Services").[10] "Non-U.S. use" means use, consumption, or disposition that occurs outside the U.S.[11] The term "sold" includes any lease,

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[6] The ratio F.D.D.E.I. to D.E.I. is also referred to as foreign derived ratio ("F.D.R.").

[7] Under the definition as expanded by the T.C.J.A., a non-U.S. corporation is a C.F.C. if more than 50% of the voting power or value of all shares outstanding are owned by one or more U.S. Shareholders. A U.S. person is a U.S. Shareholder if it owns at least 10% of the voting power or value of all outstanding shares of the foreign corporation.

[8] Code §250(b)(3)(A)(i)(VI).

[9] Code §250(b)(2)(A).

[10] Code §250(b)(4).

[11] Code §250(b)(5). Specific rules exist for non-U.S. related-party transactions.

license, exchange, or other disposition.[12] Specific rules exist (i) for property or services provided to a U.S. intermediary and (ii) with respect to related-party transactions.[13]

Finally, the F.D.I.I. deduction, increased by the G.I.L.T.I. and the related Code §78 gross-up deductions, is subject to a taxable income limitation.[14] If this aggregate amount exceeds the corporation's taxable income (determined without regard to these deductions), the excess reduces the G.I.L.T.I. and F.D.I.I. amounts *pro rata*.

"F.D.D.E.I. is D.E.I. derived in connection with (i) property sold to a non-U.S. person for non-U.S. use and (ii) services provided by the taxpayer to persons, or with respect to property, located outside the U.S."

WHO CAN BENEFIT FROM THE REGIME?

Domestic corporations and domestic corporate partners can benefit from the regime.

The proposed regulations clarify that for purposes of the F.D.I.I. regime, a domestic corporation is defined by reference to Code §7701(a).[15] Thus, it is available to associations, joint-stock companies, or insurance companies created or organized in the U.S. or under the law of the U.S. or of any state, with the exception of regulated investment companies, real estate investment trusts, or S-corporations. This implies that entities formed in the U.S., and that elect to be treated as corporations for U.S. tax purposes, are allowed the F.D.I.I. deduction if the requirements of the regime are otherwise met.

Further, a direct or indirect domestic corporate partner of a partnership takes into account its distributive share of the partnership's gross D.E.I., gross F.D.D.E.I., partnership deductions, and partnership Q.B.A.I.[16] Essentially, the F.D.I.I. computation is made at the corporate partner level on an aggregate basis and not at the partnership level. Since the Code §250 deduction is computed at the corporate partner level, it does not increase the corporate partner's outside basis in the partnership.[17]

HOW ARE DEDUCTIONS TAKEN INTO ACCOUNT?

Does the Taxable Income Limitation Take into Account Limitations Related to Interest Deductions and N.O.L. Deductions?

As explained earlier, the F.D.I.I., G.I.L.T.I., and related Code §78 gross-up deductions cannot exceed the taxpayer's taxable income. In other words, the taxpayer cannot benefit from a loss under these rules.

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[12] Code §250(b)(E).

[13] Code §250(b)(5).

[14] "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?"

[15] Prop. Treas. Reg. §1.250(a)-1(c)(1).

[16] Prop. Treas. Reg. §§1.250(b)-1(e), 2(g). While Code §250(a)(1) allows a deduction to a domestic corporation, it does not provide rules for domestic corporations that are partners in a partnership. However, the preamble to the proposed regulations clarifies that the conference report accompanying the T.C.J.A. suggests that Congress intended that a domestic corporate partner of a partnership receive the benefit of a Code §250 deduction for its F.D.I.I. and G.I.L.T.I. (Preamble to the proposed regulations referencing H. Rept. 115-466, at 623, n. 1517 (2017)).

[17] Preamble to the Prop. Treas. Reg., Section 3, p. 16.

However, the very definition of "taxable income" is not provided for purposes of Code §250. Certainly, the concept of "taxable income" entails net basis taxation, *i.e.*, taking into account appropriate deductions. Further, several provisions, such as Code §§163(j), 172, and 250, contain a deduction limitation based, in one shape or another, on taxable income. The central question then becomes, "How do these various limitations apply and interrelate?"

The proposed regulations address this issue by clarifying the interaction between Code §§172, 163(j), and 250. More specifically, the proposed regulations provide an ordering rule for determining the taxable income or adjusted taxable income limitations applicable to each provision. They provide that the Code §172 limitation is determined without a taxpayer's Code §250 deduction, and a taxpayer's adjusted taxable income for the interest expense limitation of Code §163(j) is determined without the net operating loss ("N.O.L.") provisions of Code §172.

More specifically, the taxpayer must follow the following consecutive steps:

1. **Tentative §250 Deduction:** Consider all other deductions except for Code §§163(j) and 172, and the Code §250 taxable income limitation.

   A taxpayer computes a tentative Code §250 deduction and a tentative F.D.I.I. amount by taking into account all deductions with the exception of (i) interest expense carryforwards or disallowances under Code §163(j), N.O.L. deductions under Code §172(a), and (iii) the Code §250 taxable income limitation.

2. **Allowed Interest Deduction:** Consider tentative Code §250 deduction but not Code §172 deduction.

   The taxpayer computes its allowed interest deduction pursuant to Code §163(j), taking into account its tentative Code §250 deduction computed under Step 1 but not the N.O.L. deductions allowed under Code §172(a).

3. **N.O.L. Deduction:** Consider Code §§163(j) and 172 but not Code §250 actual and tentative deductions.

   The taxpayer determines its N.O.L. deduction, taking into account the allowed interest expense deduction under Code §163(j) and the taxable income limitation of Code §172(a)(2) but without regard to its tentative Code §250 deduction or its actual Code §250 deduction.

4. **F.D.I.I.:** Consider Code §163(j) and N.O.L. deduction.

   The taxpayer computes its F.D.I.I. after taking into account its allowable interest expense deduction under Code §163(j) (as determined under Step 2) and its N.O.L. deduction (as determined under Step 3).

5. **Code §250 Deduction:** Consider Code §§163(j) and 172, and the Code §250 taxable income limitation.

   The taxpayer computes its Code §250 deduction by taking into account its business interest deduction under Code §163(j), its N.O.L. deduction under Code §172(a), and its Code §250 taxable income limitation.

The proposed regulations include a comprehensive example that illustrates the operation of this rule and the interplay between the provisions of Code §§163(j) and

172(a).[18] Comments on the ordering rules are invited by the Treasury.

Are There Other Limitations Related to Allowable Deductions?

A domestic corporation could have a loss F.D.D.E.I. amount when costs associated to F.D.D.E.I. services or sales exceed the income therefrom. This, in turn, could decrease the domestic corporation's F.D.D.E.I. to D.E.I. ratio, thus decreasing the effective Code §250 deduction.

As explained below, domestic corporations wishing to benefit from the Code §250 deduction must generally comply with substantial documentation requirements in order to qualify for the deduction. However, when their ratio would be decreased because of loss F.D.D.E.I., the I.R.S. is warry that such taxpayers may intentionally fail to comply with the documentation requirements in order to exclude the loss F.D.D.E.I. altogether, thus avoiding a decrease in their F.D.I.I. deduction. As a result, and only in the context of loss F.D.D.E.I., the sale of property or the provision of a service will still be treated as F.D.D.E.I. if said treatment would result in the reduction of a corporation's F.D.D.E.I.

The effect of non-recognition of an F.D.D.E.I. loss on the F.D.I.I. deduction becomes apparent in the following example:

Example

Assume that after deduction of allocable cost of goods sold, U.S. corporation Y derives gross income or losses from F.D.I.I. eligible sales to foreign persons as follows:

- Product A: Loss of $50
- Product B: Gross income of $600
- Product C: Gross income of $550

D.E.I. amounts to $2,400, and D.I.I. is $100.

Taking into account the loss from the sale of Product A, the F.D.R. would amount to 47% (1150 divided by 2400). Hence, Y's F.D.I.I. would be $47 (100 * 47%); whereas, if Y excluded the loss, its F.D.I.I. would increase to $50 (100 * [1200/2400]). Accordingly, while generally losses cannot be incurred for purposes of F.D.I.I. determination, the F.D.D.E.I. loss must be taken into account by the taxpayer in order to avoid dilution of the F.D.R.[19]

IS THE DEDUCTION ALWAYS AVAILABLE WHEN A U.S. CORPORATION SELLS ON A FOREIGN MARKET?

An important aspect is the exclusion of foreign branch income from the definition of F.D.I.I. Thus, not all income generated from sales to a foreign market can benefit from the Code §250 F.D.I.I. deduction.

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18 Prop. Treas. Reg. §1.250(a)-1(f), ex. 2.

19 See also the example under Prop. Treas. Reg. §1.250(b)-3(f)(2) (limited to the F.D.R. impact).

> *"Income from servicing the foreign market may be excluded altogether from the definition of F.D.I.I. if the taxpayer directly or indirectly operates through a permanent establishment in the foreign country."*

As explained earlier, F.D.I.I. does not include foreign branch income.[20] Foreign branch income is defined by reference to the foreign tax credit provision of Code §904(d)(2)(J) and to proposed foreign tax credit regulations of Prop. Treas. Reg. §1.904-4(f). Foreign branch income is defined as business profits, but not passive category income, of a U.S. person attributable to a qualified business unit ("Q.B.U.") in a foreign country. The notion of Q.B.U. comes from Subpart J of the Code dealing with foreign currency transactions. For foreign currency transaction purposes, a Q.B.U. is a separate and clearly identified unit of a trade or business of a taxpayer maintaining separate books and records.[21] Thus, a "foreign branch" is not necessarily the equivalent of a trade or business for foreign currency transaction purposes. However, the proposed foreign tax credit regulations under Prop. Treas. Reg. §1.904-4(f)(3), while defining a Q.B.U. by reference to the foreign currency transaction rules, add a requirement that the Q.B.U. conducts a trade or business outside the U.S. They also specify that a non-U.S. permanent establishment of a U.S. taxpayer under an applicable income tax treaty is presumed to constitute a qualifying non-U.S. trade or business.

Notably, the proposed regulations under Code §250 go even further by including in foreign branch income (and thus excluding from F.D.I.I.) the income from the direct or indirect sale of any asset (other than stock) producing gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest.[22] This encompasses any sale, lease, license, exchange, or disposition of property, including property transfers in which gain or income is recognized under Code §367.[23] Under these rules, transfers of intangible property ("I.P."), as defined under Code §367(d)(4), between a foreign branch owner and a foreign branch are recharacterized. As a result, for F.D.I.I. purposes, it is not sufficient for a U.S. corporation to ultimately sell its property or services to a foreign market. Rather, it must be aware that its entire income from servicing the foreign market may be excluded altogether from the definition of F.D.I.I. if the taxpayer directly or indirectly operates through a permanent establishment in the foreign country. Taxpayers should seize the opportunity to comment on such adverse implications of the proposed foreign branch rules in order to limit their applicability and, thus, the limitation for F.D.I.I. purposes.

HOW IS THE FOREIGN USE OF SALES OR SERVICES ESTABLISHED?

The proposed regulations establish the foreign use differently for sales of property and services.

An interesting point to note is that the proposed regulations treat a partnership as a person for purposes of determining whether a sale of property or services constitutes an F.D.D.E.I. sale or an F.D.D.E.I. service, respectively. One of the results is that an otherwise qualifying sale to a domestic partnership will not qualify as an F.D.D.E.I. sale, whereas the same sale to a foreign partnership may. Thus, the

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20 Code §250(b)(3)(A)(i)(VI).

21 Code §989(a).

22 Prop. Treas. Reg. §1.250(b)-1(c)(11).

23 Prop. Treas. Reg. §1.250(b)-3(b)(7).

partnership is not considered an aggregate of its partners for this purpose. This approach is, however, not carved in stone. The Treasury and the I.R.S. request comments on whether applying the aggregate concept for partnerships would be appropriate in certain instances.

Equally important to note is that in addition to licenses, leases, and exchanges, the term "sale" also includes transfers of property resulting in gain or income inclusion under Code §367.[24]

Finally, when a transaction includes the sale of services and the sale of property, it is classified according to the overall predominant character of the transaction.[25]

Sale of Property

Sales of property cannot qualify as F.D.D.E.I. sales if they are made to a U.S. person, even if that person is located outside the U.S.

A sale of property qualifies as an F.D.D.E.I. sale if it is (i) made to a foreign person and (ii) for a foreign use.[26]

Further, F.D.D.E.I. sales are divided into two categories for purposes of determining foreign use: sales of general property and sales of I.P.:

- **Sale to a Foreign Person:** A sale can be treated as made to a foreign person only if documentation reflecting foreign status is obtained by the seller. Small businesses (less than $10 million in gross receipts in the previous taxable year) or taxpayers entering into small transactions (less than $5,000 in gross receipts from a single recipient during the current taxable year) can rely on a mere foreign shipping address.[27]
- **Sale for a Foreign Use:** The rules for determining foreign use are not the same for general property and I.P., as defined by reference to Code §367(d)(4).[28] General property is defined as any property other than (i) I.P., (ii) a security, or (iii) a commodity.[29] For both general property and I.P., documentation requirements must be met. Then, the requirements vary:
    - For general property, foreign use is established if (i) the property is not subject to U.S. use within three years of delivery or (ii) the property is subject to manufacture, assembly, or other processing outside the U.S. before any domestic use of the property.

      The proposed regulations go even further by defining what manufacture, assembly, or other processing means for this purpose: Either, there is a physical and material change to the property, or the property is incorporated as a component into a second product.

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24 Prop. Treas. Reg. §1.250(b)-3(b)(7).

25 Prop. Treas. Reg. §1.250(b)-3(e).

26 Prop. Treas. Reg. §1.250-4(b).

27 Prop. Treas. Reg. §1.250(b)-4(c)(2)(ii).

28 Prop. Treas. Reg. §1.250(b)-3(b)(4).

29 For this purpose, securities and commodities are defined in reference to Code §§475(c)(2), 475(e)(2)(B), (C), and (D).

The former is a factual test, while the second is a mathematical one: General property is incorporated as a component into a second product to the extent its fair market value upon delivery to the recipient constitutes 20% or less of the fair market value of the second product when such second product is completed. Special rules exist for fungible goods and transportation property.

- For I.P., foreign use is generally established when revenue is earned from exploiting the I.P. outside the U.S. (and the documentation requirements are otherwise met). It is noteworthy that a sale of I.P. includes a license and any transfer that would result in gain or income recognition under Code §367, including a transfer of I.P. subject to Code §367(d).

Sale of Services for a Foreign Use

Contrary to a sale of property, a service may qualify as an F.D.D.E.I. service even if the transaction is with a U.S. person. The emphasis here is on the non-U.S. location of the recipient and of the property. The determination as to the location of the service recipient is reminiscent of the European V.A.T. rules. It would be interesting to determine to what extent European V.A.T. filings could be used by the recipients to provide the information that the service provider needs in order to meet its documentation requirements. The same logic can be applied to the sale of property.

If the proposed regulations are adopted in their current version, F.D.D.E.I. services will be divided into four mutually exclusive groups:[30]

- **Transportation Services:** The emphasis here is on the origin and destination of the services. Transportation services are services to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation. The services must be provided to a recipient or with respect to property located outside the U.S. The location is determined based on the origin and destination of the service.[31] If both are outside the U.S., the service is an F.D.D.E.I. service. If one is inside the U.S., only 50% of the service is F.D.D.E.I.

- **Property Services:** The emphasis here is on the location of the property. Property services are services, other than transportation services, provided with respect to tangible property located outside the U.S. Substantially all of the service must be performed where the property is located and must result in physical manipulation of the property. The property must be located outside the U.S. throughout the performance of the service. Examples include assembly, maintenance, or repair. For this purpose, "substantially" means that more than 80% of the time providing the service is spent at or near the location of the property.

- **Proximate Services:** The emphasis here is on the location of performance. Proximate services are services, other than property services or transportation services, provided to a recipient located outside the U.S., if substantially all of the service is performed in the physical presence of the recipient or the

[30] Prop. Treas. Reg. §1.250(b)-5(b).

[31] Prop. Treas. Reg. §1.250-(b)-5(h).

recipient's employees (in the case of a business recipient). For this purpose, "substantially" means that more than 80% of the time providing the service is spent in the physical presence of the recipient or its employees.[32] Apportionment rules exist for proximate services rendered both within and outside the U.S.

- **General Services:** The emphasis here is on the location of the recipient. General services constitute the default category. They encompass all services not included in the other categories, provided the recipient is located outside the U.S. General services are divided into two broad categories. One consists of services directed at individual consumers located outside the U.S. who use the service for personal needs (business-to-consumer or "B2C"). The other consists of services directed at business recipients located outside the U.S. (business-to-business or "B2B"). For this purpose, a consumer is an individual purchasing the service for personal consumption, and a business recipient is any other recipient (whether or not such recipient is engaged in a trade or business).

  ○ For B2B services, the service is generally provided to a business recipient outside the U.S. if (i) the business recipient is located outside the U.S., (ii) the service provider's gross income from providing the services is allocated to the business recipient's operations outside the U.S., and (iii) the service provider obtains supporting documentation establishing the location of the service recipient.[33]

    Supporting documentation includes (i) a written statement by the service recipient, (ii) a binding contract specifying the locations of the operations of the business recipient that benefit from the service, (iii) documentation obtained during the course of the provision of the service, (iv) publicly available information establishing the location of the operations, and (v) any other type of documentation prescribed by the I.R.S.[34]

    Special rules exist for business receiving less than $10 million in gross receipts during a prior taxable year.

  ○ For B2C services, the emphasis is on the location of the consumer. Generally, this location is where the consumer resides at the time the service is provided.[35]

    Here again, documentation requirements must be met, and exceptions exist with regard to small businesses or small transactions.[36]

"Sales of property and services to a domestic unrelated party do not qualify as F.D.D.E.I. sales or services."

As a summary of the above and in line with the provisions of Code §250(b)(5)(B), sales of property and services to a domestic unrelated party do not qualify as F.D.D.E.I. sales or services, even if the domestic unrelated party uses the property and services for a foreign use.

32 Prop. Treas. Reg. §1.250(b)-5(c)(6).

33 Prop. Treas. Reg. §1.250(b)-5(e)(2)(i).

34 Prop. Treas. Reg. §1.250(b)-5(e)(3).

35 Prop. Treas. Reg. §1.250-5(d)(2).

36 Prop. Treas. Reg. §1.250-5(d)(3).

CAN RELATED-PARTY TRANSACTIONS QUALIFY AS F.D.D.E.I. SALES OR SERVICES?

Yes, if specific requirements are met.

For this purpose, a party is related to a person if it is a member of a modified affiliated group including such person. For this purpose, a "modified affiliated group" is defined as one or more chains of corporations connected through stock ownership with a common parent if (i) the common parent directly owns 50% by vote or value in at least one other corporation and (ii) each of the other corporations is owned directly by one or more of the other affiliated group corporations by at least 50% vote or value. In addition, any person (other than a corporation) is also part of a modified affiliated group if it controls, or is controlled, by a member of such group. For this purpose, control means direct, indirect, or constructive ownership of 50%, by value, of the beneficial interest in such person.

The proposed regulations contain guidance on related-party sales but only with respect to general property and general services. Thus, I.P. and all other categories of services appear to be excluded from the specific related-party rules. Regarding I.P., the preamble to the proposed regulations clarifies that because the general rule for such property is revenue generation from a non-U.S. exploitation of the property, no additional rules are required for related-party sales. Similarly, through their very definitions, proximate services, property services, and transportation services cannot be artificially structured to benefit from the related-party rules.

For general property, two subcategories of rules exist: one for the resale by a related party of the property and one for transactions other than the resale of purchased property. For the former category, a related-party sale is an F.D.D.E.I. sale if, essentially, the requirements for F.D.D.E.I. treatment are met at the level of the related party. Further, an unrelated-party sale must occur by the F.D.I.I. filing date in order for D.E.I. derived from the related-party sale to be treated as F.D.D.E.I.[37] For this purpose, the F.D.I.I. filing date means the filing deadline (including extensions) for the seller's or renderer's income tax return. Amended returns can be filed to claim the benefit of F.D.D.E.I. treatment, should the unrelated-party sale occur after the F.D.I.I. filing date. For the latter category, the sale qualifies as an F.D.D.E.I. sale only if, by the F.D.I.I. filing date, the seller reasonably expects that more than 80% of the revenue earned by the foreign related party from the use of the property in all transactions will be earned from unrelated-party transactions otherwise qualifying as F.D.D.E.I. transactions.

Income derived in connection with general services provided to a related party that is not located in the U.S. is treated as F.D.D.E.I. only if the taxpayer establishes to the satisfaction of the I.R.S. that such service is not substantially similar to services provided by the related party to persons located within the U.S.[38] This essentially constitutes an anti-abuse rule to prevent triangular transactions in which a U.S. service provider provides services to a non-U.S. related party that forwards the output of the services to a U.S. customer. For this purpose, a service is "substantially similar" if the renderer's service is provided to a person located within the U.S. by the related party and either the benefit test or the price test is met:

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37 Prop. Treas. Reg. §1.250-6(c).

38 Code §250(b)(5)(c)(ii).

- **Benefit Test:** The benefit test is met if at least 60% of the benefits conferred by the related-party service are to persons located within the U.S.[39]

- **Price Test:** The price test is met if the renderer's services make up for at least 60% of the price that persons located in the U.S. pay for the service provided by the related party. If the price test is met, the entire F.D.D.E.I. service is not automatically disqualified. Rather, the gross income from the related-party service will be apportioned between the benefits conferred to persons located outside the U.S. and the benefits conferred by the related party to persons located within the U.S.[40]

OTHER RELEVANT PROPOSALS

Although not elaborated in this article, the proposed regulations also address the following points with regard to F.D.I.I.:

- An anti-abuse rule to avoid the 10% Q.B.A.I. reduction
- A disallowance of F.D.I.I. treatment if the taxpayer has knowledge, or reason to know, that such treatment should not apply
- Rules for consolidated groups
- Reporting requirements

CONCLUSION

To summarize, the main focus of the proposed regulations seems to be the tracking of abusive scenarios in which foreign use appears on paper but the property or services are channeled back to the U.S. market. While the proposed regulations also address several questions raised by practitioners, they still leave open practical implications – in particular, relating to the documentation requirements for F.D.I.I. deduction eligibility.

Furthermore, before utilizing the F.D.I.I. regime, U.S. corporations would be wise to determine whether the benefits outweigh the documentation and compliance burdens. Modeling that focuses on benefits without factoring in costs of compliance will not provide a complete answer. Taxpayers should consult with tax counsel for a comprehensive analysis before making a decision.

Finally, taxpayers and their counsel are invited to comment on the proposed regulations – in particular, relating to the ordering rules for computing F.D.I.I., the negative impact of an extensive definition of foreign branch operations that are excluded from F.D.I.I., and practical implications of the suggested documentation requirements.

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39 Prop. Treas. Reg. §1.250(b)-6(d)(2)(i).

40 Prop. Treas. Reg. §1.250(b)-6(d)(1).

PEELING THE ONION TO ALLOCATE SUBPART F INCOME – THIS WILL MAKE YOU CRY!

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Tags
C.F.C.
Distribution Rights
Nonvoting Stock
Preferred Stock
Subpart F
T.C.J.A.
U.S. Shareholder

INTRODUCTION

There has been a wealth of conversation addressing the amendment to the definition of a "U.S. Shareholder" in the context of a controlled foreign corporation ("C.F.C.") introduced by the 2017 Tax Cuts and Jobs Act ("T.C.J.A."). The phrase "10% of the voting rights or 10% of the total value of shares of all classes of stock" has been discussed several dozen times in every tax journal by now. But how does it really affect the U.S. Persons (as defined) who find that they have become U.S. Shareholders? And, in particular, how does it affect those who own nonvoting preferred stock in a foreign corporation? This article answers those questions and provides an in-depth analysis of the allocation of Subpart F Income among U.S. Shareholders of a C.F.C.

PRE-T.C.J.A. TAX RULES

Before plunging into the issues, a quick recap of the law that existed prior to the pre-T.C.J.A.: A U.S. Shareholder was previously defined as a U.S. Person that owned shares of stock representing 10% or more of the total voting power of all stock of the foreign corporation.[1]

Thus, a U.S. Person holding nonvoting preferred stock representing 10% or more of the value of all shares of the foreign corporation was not treated as a U.S. Shareholder. However, the percentage of value owned by that U.S. Person was taken into account for purposes of determining whether a foreign corporation was a C.F.C. Thus, even if the foreign corporation was a C.F.C., the U.S. Person was not subject to U.S. tax under Subpart F since the person failed to meet the definition of a U.S. Shareholder, provided that the two classes of stock had economic substance and were not a subterfuge to avoid the scope of Subpart F.[2]

The T.C.J.A. expanded the definition of a U.S. Shareholder to include a U.S. Person that owns shares representing 10% or more of the value of all shares of the foreign corporation.[3]

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1 Code §951(b) under the pre-T.C.J.A. law.

2 If on the other hand, U.S. Shareholders formally owned shares representing 50% or less of the corporation's voting power, the corporation could be a C.F.C. if control existed in disguised form. See, *e.g.*, Treas. Reg. §1.957-1(b)(2), which provides in part that "any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." While this provision addresses the definition of a C.F.C. rather than a U.S. Shareholder, the principle is similar if the effect is that a U.S. Person owns shares that effectively control the foreign corporation.

3 Code §951(b) as amended by the T.C.J.A.

As a result, a U.S. Person holding only nonvoting preferred shares will be swept within the definition of a U.S. Shareholder if the value of the nonvoting preferred shares is 10% or more of the total value of shares of all classes of stock.[4] The *pro rata* share of the corporation's Subpart F Income will be included in the gross income of the U.S. Shareholder. If the U.S. Person is an individual, the person will be taxed at ordinary tax rates (*i.e.*, the tax rate based on the tax bracket applicable to the U.S. Shareholder and not the highest effective tax rate).[5] In the case of a corporation, Subpart F Income is taxed at 21%.

ALLOCATION OF SUBPART F INCOME

Once a U.S. Person becomes a U.S. Shareholder of a C.F.C., that person is required to include a *pro rata* share of the C.F.C.'s Subpart F Income in gross income.[6] The determination of the *pro rata* share of Subpart F Income is dependent on several factors, such as the following:

- Whether the foreign corporation is a C.F.C. for the full tax year
- Whether the U.S. Person is a U.S. Shareholder for the full tax year
- Whether the C.F.C. declared actual dividends during the year to prior owners of the same shares
- Whether the C.F.C. has one or more classes of stock outstanding
- Whether the board of directors of the C.F.C. has discretionary rights to distribute dividends to the stockholders

"A U.S. Shareholder of a C.F.C. . . . is required to include a pro rata *share of the C.F.C.'s Subpart F Income in gross income."*

How Subpart F Income is allocated to a U.S. Shareholder and the effect of the above factors are the main focus of this article.

The Code and the regulations provide a complex formula to determine a U.S. Shareholder's *pro rata* share of Subpart F Income includable in gross income. Generally, a U.S. Shareholder's *pro rata* share is the amount that would have been received with respect to stock owned in the C.F.C. under the rules of Code §958(a) if the C.F.C. actually distributed its Subpart F Income ("Hypothetical Distribution") as dividends to shareholders on the last day of its taxable year ("Hypothetical Distribution Date").[7] In simplest terms, the *pro rata* share of Subpart F Income can be determined in the following steps:[8]

1. A Hypothetical Distribution of Subpart F Income is deemed to have been made on the last day of the tax year in which the foreign corporation is a C.F.C.
2. The Hypothetical Distribution is limited to the amount that is attributable to the period for which the foreign corporation is a C.F.C. In other words, the total

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[4] The theory is that if a U.S. Person owns shares representing substantial value, the person will take steps to protect its interest in the operations of the foreign corporation.

[5] Code §951(a)(1).

[6] Code §951(a)(1)(A).

[7] Code §951(a)(2); Treas. Reg. §1.951-1(b).

[8] *Id.*

Subpart F Income under Step 1 is multiplied by the percentage of the year during which the foreign corporation qualifies as a C.F.C.

3. The amount determined in Step 2 is allocated to the U.S. Shareholder based on the percentage of its ownership interest held in the C.F.C. For Step 3, the direct and indirect ownership determined under Code §958(a) is considered. Stock owned constructively under Code §958(b) using modified constructive ownership rules of Code §318 is ignored in this step.

4. The amount determined under Step 3 is reduced by the lesser of the following to arrive at the *pro rata* share of Subpart F Income of the C.F.C. attributable to the U.S. Shareholder:

   a. The amount equal to the actual dividends received by persons other than the U.S. Shareholder (*i.e.*, prior stockholders, if any) with respect to the same shares of stock

   b. The amount that the prior stockholders would have received if the total distributions had equaled the foreign corporation's Subpart F Income for the year multiplied by the percentage of the year during which the U.S. Shareholder did not own the stock (directly or indirectly)

DETERMINATIONS IN VARIOUS FACT PATTERNS

A C.F.C. with Only One Class of Stock Outstanding

When a C.F.C. has only one class of stock outstanding during the year, a U.S. Shareholder's *pro rata* share of the C.F.C.'s Subpart F Income is the amount that would have been received by such U.S. Shareholder had the C.F.C. made a *pro rata* dividend distribution of its Subpart F Income to all of its shareholders on the last day of its taxable year. Subpart F Income is allocated on a per share basis.[9] The above can be illustrated with the help of the following examples:

Example 1

Facts:

F.C. X is a foreign corporation. One hundred shares of common stock are outstanding for the entire year. On January 1, 2018, A, a U.S. Person, owns 60 shares and B, also a U.S. Person and A's spouse, owns 10 shares of the common stock. The remaining 30 shares are owned by foreign persons. F.C. X is a C.F.C. under Code §957(a). On May 26, 2018, A sells all holdings of the F.C. X stock to C, a foreign individual. At that point, only 10% of the F.C. X stock is owned by a U.S. Person, B Consequently, F.C. X ceases to be a C.F.C. after May 26, 2018. All parties have the calendar year as the tax year. F.C. X has $100 of Subpart F Income for the entire 2018 tax year and has $200 of earnings and profits ("E&P"). It makes no distributions during 2018.

Analysis:

A and B are U.S. Shareholders under Code §951(b) since both own 10% or more of the stock of F.C. X. In addition, F.C. X is a C.F.C. because more than

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9 Treas. Reg. §1.951-1(e)(2).

50% of the voting power is owned by U.S. Shareholders, A and B. The *pro rata* share of F.C. X's Subpart F Income allocable to A and B can be determined by following the above-mentioned steps:

1. A Hypothetical Distribution of Subpart F Income is deemed to have been made on the last day of the tax year in which F.C. X is a C.F.C. Thus, it is assumed that F.C. makes a distribution of its Subpart F Income of $100 as on December 31, 2018.

2. The E&P for the year exceeds the Subpart F Income, and for that reason, the limitation based on E&P is not relevant.

3. The total Subpart F Income under Step 1 is multiplied by the percentage of the year during which F.C. X is a C.F.C. to ensure that only the Subpart F Income attributable to the period during which F.C. X is a C.F.C. is allocated to the U.S. Shareholders. F.C. X's Subpart F Income for the period during which it is a C.F.C. (January 1, 2018 through May 26, 2018) is $40 ($100 * 146 / 365).

4. When a C.F.C. has only one class of stock, Subpart F Income is allocated on a per share basis. Stated differently, it is allocated based on the percentage of the ownership interest held by the U.S. Shareholders in the C.F.C. A must include $24 in his gross income as his *pro rata* share of Subpart F Income for 2018 (60 shares / 100 shares * $40). Although Code §958(b) treats A as constructively owning B's 10% interest in F.C. X under spousal attribution rules, such constructive ownership is ignored in computing A's *pro rata* share of F.C. X's Subpart F Income. Similarly, B must include $4 in her gross income as her *pro rata* share of Subpart F Income for 2018 (10 shares / 100 shares * $40). The constructive ownership of A's 60% interest in F.C. is ignored when determining B's *pro rata* share of Subpart F Income.

Example 2

Facts:

The facts are the same as in Example 1, except that A initially acquired 60% of the stock of F.C. X on May 26, 2018, from N, a foreign person who owned the stock interest for many years. Thus, N owned the shares at all times in 2018 leading up to the date of sale. Before A's acquisition of the shares of stock in F.C. X, F.C. X distributed a dividend of $15 to N in 2018 with respect to the shares of stock subsequently sold to A.

Analysis:

1. A Hypothetical Distribution of F.C. X's Subpart F Income ($100) is made as of December 31, 2018.

2. The total Subpart F Income under Step 1 is multiplied by the percentage of the year during which the foreign corporation was a C.F.C. F.C. X is a C.F.C. from May 26, 2018, through December 31, 2018, because more than 50% of the voting rights of all shares is held by U.S. Shareholders. Subpart F Income allocable to the period from May 26 through December 31, 2018 (219 out of 365 days) is $60 ($100 * 219 / 365).

3. Subpart F Income determined under Step 2 is allocated to A based on his ownership interest in F.C. X. A's *pro rata* share of Subpart F Income is $36 (60% of $60). Similarly, B's *pro rata* share of Subpart F Income is $6 (10% of $60).

4. A's *pro rata* share of Subpart F Income under Step 3 is reduced by the lesser of the following:

   a. The amount equal to the actual dividends received by N with respect to the same stock as owned by A as on December 31, 2018 (*i.e.*, $15)

   b. The amount that N would have received if the total distributions had equaled the foreign corporation's Subpart F Income for the year multiplied by the percentage of the year during which the U.S. Shareholder did not own the stock directly or indirectly (*i.e.*, $24 or 60% of $100 * 143 / 365)

   The *pro rata* share of Subpart F Income of F.C. X to be included in A's 2018 gross income is $21 ($36 reduced by the lesser of $15 or $24).

The determination of the *pro rata* share of Subpart F Income of a U.S. Person who owns 10% or more of the stock (by reason of having 10% or more of the voting power as opposed to owning 10% or more of the total value) in a foreign corporation does not require continuous vigilance. This is because a U.S. Person typically enters into a stockholder's agreement with the corporation, which grants the voting rights, and the U.S. Person is treated as owning the stock from the effective date of the agreement. Thus, Subpart F Income can be prorated for the period starting from the effective date of the agreement through the end of the C.F.C.'s tax year or an earlier date where the U.S. Shareholder sold its stock before the end of the tax year.

"A foreign corporation is at risk if it does not undertake a valuation of its net worth and the value of each class of shares . . . each time it makes substantial investments or earns considerable profits."

In comparison, the determination of the *pro rata* share is uncertain in case of a U.S. Person who owns 10% or more of the total value of all classes of stock. The 10%-of-value threshold requires continuous analysis throughout the year and is not confined only to the last day of the C.F.C.'s tax year. Thus, if a U.S. Person is said to own 10% or more of the total value of the foreign corporation at any time of the year, the foreign corporation will be treated as a C.F.C. where all other conditions are met for C.F.C. status to exist. Consequently, the change in the definition of a U.S. Shareholder causes a foreign corporation to be mindful of its net worth and the total value of all shares of stock held by U.S. Persons. Hence, a foreign corporation is at risk if it does not undertake a valuation of its net worth and the value of each class of shares – or perhaps each sizeable block of shares under common ownership – each time it makes substantial investments or earns considerable profits.

When a C.F.C. Has More than One Class of Stock Outstanding and One or More Classes of Stock Have Only Nondiscretionary Distribution Rights

The abovementioned standalone four-step analysis is relatively straightforward for a C.F.C. having only one class of stock. However, Treas. Reg. §1.951-1(e)(3)(i)[10]

10 The I.R.S. issued proposed regulations on October 10, 2018, amending Treas. Reg. §1.951-1(e)(3) to provide that the E&P Distributable among different classes of stock is based on the distribution rights (as opposed to the fair market value test (as discussed later in the article) of each class. Further, the distribution rights of a class are determined by taking into account all facts and

requires additional analysis for a C.F.C. having more than one class of stock outstanding of which one or more of the outstanding classes of stock have only nondiscretionary distribution rights. A class of stock is said to have nondiscretionary distribution rights if the corporation is obligated to declare a fixed rate of return based on the face value of the shares (*e.g.*, fixed rate of 5% on face value of preferred stock).

Treas. Reg. §1.951-1(e)(3)(i) provides as follows:

> If a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income . . . for the taxable year taken into account with respect to any one class of stock . . . shall be that amount which bears the same ratio to the total of such subpart F income . . . for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year (not reduced by actual distributions during the year) were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation (the hypothetical distribution date), bear to the total earnings and profits of such corporation for such taxable year.

Let's translate the above into English and then see how the underlying arithmetic works in practice. Broken into is principal clauses, the foregoing provision of the regulations provides as follows: Subpart F Income attributable to a class of stock will be (i) that proportion of the C.F.C.'s Subpart F Income that (ii) the E&P Distributable to such class in a Hypothetical Distribution of all the C.F.C.'s E&P (not reduced by actual distributions) would bear to (iii) the C.F.C.'s total E&P for the year.

***Pro Rata* Share of Subpart F Income of U.S. Shareholder Owning Class A Shares of Common Stock:**
$\dfrac{\text{E\&P Distributable to Class A in Hypothetical Distribution}}{\text{Total E\&P of C.F.C.}} * \text{C.F.C.'s Subpart F Income}$

In other words, the numerator (E&P Distributable) is the amount of the E&P that would have been distributed to a particular class of stock (Class A) if the entire E&P was deemed to have been distributed at the end of the C.F.C.'s tax year.

Consequently, if a C.F.C. has only one class of stock, Subpart F Income is deemed to be distributed on the Hypothetical Distribution Date based on the ownership of that single class. In comparison, when the C.F.C. has more than one class of stock:

1. The first step is to compute E&P rather than Subpart F Income.

2. The second step is to allocate the E&P Distributable based on the way it would be distributed to the holders of the various classes of shares on the Hypothetical Distribution Date.

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circumstances related to the economic rights and interest in the current E&P of each class, including the terms of the class of stock and any agreement between the shareholders. However, these rules will be effective only after they become final. In the meantime, the current final regulations are effective.

3. Once the E&P Distributable is computed and then allocated to each particular class of shares, the third step is that Subpart F Income is allocated in the same percentages to each of those classes.

4. The final step within each class of shares is to apportion the Subpart F Income allocable to each share within a particular class, which is deemed to be distributed on the distribution date. In essence, the last step of the process follows the default rule when only one class of stock is issued and outstanding. The attribution of Subpart F Income among holders of various classes of shares follows the waterfall of earnings among those classes.

"Subpart F Income attributable to a class of stock will be (i) that proportion of the C.F.C.'s Subpart F Income that (ii) the E&P Distributable to such class in a Hypothetical Distribution of all the C.F.C.'s E&P (not reduced by actual distributions) would bear to (iii) the C.F.C.'s total E&P for the year."

Meaning of E&P Distributable with Respect to Preferred Stock

With respect to a preferred stock that has the right to a fixed rate of return (*viz.*, non-discretionary distributions), this amount is typically the amount of the dividends mandatorily payable to the preferred stockholders prior to the distribution of dividends to holders of common shares. The preference must be honored, and the board of directors must have an actual obligation to pay the nondiscretionary dividends prior to discretionary dividends. If the terms of the shareholder's agreement are such that the obligation to pay the dividend may or may not arise in the C.F.C.'s taxable year in question (depending on an exercise of discretion by the C.F.C.'s board of directors), the stock will be deemed to have discretionary distribution rights. In such cases, the allocation rule under Treas. Reg. §1.951-1(e)(3)(ii) would apply (discussed in the next section of the article).[11]

Meaning of E&P Distributable with Respect to Common Stock

The balance of the E&P remaining after paying the nondiscretionary distributions is the E&P Distributable to the common stockholders.

A Stock Redemption Amount Is Not Treated as E&P Distributable in the Hypothetical Distribution

In determining E&P Distributable to a class of stock, the amount paid in redemption of a class stock, in liquidation, or as a return of capital is ignored.[12] The rule applies even if the redemption is treated as a dividend under Code §302(a). This implies that if the preferred stock is redeemed by a C.F.C., the redemption amount is not treated as E&P Distributable to the preferred stock in the Hypothetical Distribution. In other words, the redemption amount is not included in the numerator of the formula used for calculating the *pro rata* share of Subpart F Income of the preferred shareholder.

The above provision serves as an anti-abuse rule to prevent the shifting of Subpart F Income to a non-U.S. Person who owns redeemable or retractable shares of preferred stock of a C.F.C. in circumstances where the redemption would be treated as a dividend for U.S. income tax purposes. Dividend treatment is mandated where the redemption fails to meet any of the tests of Code §302(b):

- It is essentially equivalent to a dividend.[13]

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11 Preamble to Final Treasury Regulations 1.951-1 dated August 9, 2005

12 Treas. Reg. §1.951-1(e)(3)(i).

13 Code §302(b)(1). This test is a catch-all that applies when none of the objective tests are met. It is a facts and circumstances test, which allows capital gain

- It is not substantially disproportionate redemption.[14]
- It is not a redemption of all of a shareholder's stock.[15]
- It is not a partial liquidation.[16]

An example would involve (i) a non-U.S. Person (ii) who holds 80 shares of common stock in a non-U.S. corporation for which 100 shares of common stock have been issued and are outstanding and 50 shares of preferred stock bearing a coupon have been issued and are outstanding; (iii) ten shares of preferred shares are redeemed; (iv) the foreign country treats the redemption as a sale or exchange for tax purposes; and (v) U.S. tax law treats the redemption as a dividend under Code §302(d).[17] (It is assumed that the preferred shares do not meet the definition of Section 306 Shares.)[18] In the foregoing circumstances, the redemption is not substantially disproportionate because (i) none of the tests described in note 17 have been met, (ii) the redemption is essentially equivalent to a dividend, and (iii) neither of the remaining tests for capital gain distribution are applicable to the facts. Consequently, the redemption proceeds will be given dividend treatment to the extent of the E&P of the foreign corporation. Nonetheless, the transaction does not attract any of the C.F.C.'s E&P for purposes of apportioning Subpart F Income. Stated differently, the amount of the redemption price is not includible in E&P Distributable to the class of shares redeemed. See Example 8, below.

The method of computing the amount of E&P Distributable to a class of stock can be illustrated with the help of the following examples.

Example 3[19]

Facts:

F.C. X, a C.F.C., has issued 70 shares of common stock and 30 shares of nonparticipating, voting, preferred stock having a par value of $10 per share and bearing a coupon of 4%. All of the shares are outstanding in 2018. The common shareholders are entitled to dividends when declared by the board of directors. Corp A is a U.S. corporation and a U.S. Shareholder of F.C. X. It owns all of the common shares. Individual B, a foreign individual, owns all of the preferred shares.

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treatment for the redemption.

14 Code §302(b)(2).

15 Code §302(b)(3).

16 Code §302(b)(4).

17 Code §302(b)(2)(B) sets an objective standard by which a redemption would be treated as substantially disproportionate. In broad terms, (i) the shareholder receiving the distribution must own shares representing less than 50% of the total combined voting power, (ii) the percentage of voting shares must be reduced by more than 20%, and (iii) the percentage of common shares held in the corporation – whether voting or nonvoting – must be reduced by more than 20%.

18 Under Code §306, the amount realized from the redemption of Section 306 Shares is treated as a dividend. If the amount realized results from a sale, it is treated as ordinary income.

19 Based on Treas. Reg. §1.951-1(e)(6), ex.2

For 2018, F.C. X has $100 of E&P, of which $50 arises from Subpart F Income. In 2018, F.C. X distributes nondiscretionary dividends of $12 (4% of $300) to Individual B with respect to his preferred shares. F.C. X makes no other distributions during that year.

Analysis:

1. F.C. X has two classes of stock – common stock and preferred stock.

2. The class of preferred stock has a nondiscretionary distribution right to receive 4% dividends each year. Therefore, Subpart F Income will be allocated in accordance with Treas. Reg. §1.951-1(e)(3)(i).

3. If $100 of E&P were distributed on December 31, 2018, $12 would be mandatorily distributed with respect to Individual B's preferred shares.

4. The remainder, $88, would be distributed with respect to Corp A's common shares.

5. Accordingly, under Treas. Reg. §1.951-1(e)(3)(i), Corp A's *pro rata* share of F.C. X's Subpart F Income is $44 for taxable year 2018 ($88 / $100 * $50).

6. The 4 Step analysis is not required since F.C. X is a C.F.C. for the full taxable year, Corp A owns 100% of the common stock, B owns 100% of the preferred stock, and no actual dividends have been distributed by F.C. X other than the 4% dividend on preferred shares.

Example 4

Facts:

F.C. X, a C.F.C. has issued the following classes of stock, all of which are outstanding:

- 50 shares of common stock, of which A, a U.S. citizen, owns 30 and N, a foreign individual, owns 20
- 120 shares of nonparticipating, nonvoting, preferred stock with a par value of $100 per share and bearing a coupon of 6% (30 shares owned by A and 90 shares owned by N)

For 2018, F.C. X has $1,000 of E&P, of which $500 arises from Subpart F Income.

Analysis:

1. F.C. X has two classes of stock: common stock and preferred stock.

2. The preferred stock provides for a nondiscretionary distribution right to receive 6% dividends each year. Therefore, Subpart F Income will be allocated in accordance with Treas. Reg. §1.951-1(e)(3)(i).

3. The 4-Step analysis will be required to determine the *pro rata* share of Subpart F Income allocable to A since he owns less than 100% of the common stock and preferred stock.

a. If F.C. X makes a Hypothetical Distribution on the last day of its tax year (*i.e.*, December 31, 2018), the E&P of $720 (6% of $12,000) would be distributed with respect to the preferred stock. Accordingly, Subpart F Income allocated to the preferred stock is $360 ($720 / $1,000 * $500).

   The balance E&P of $280 ($1,000 - $720) would be distributed with respect to the common stock. Accordingly, Subpart F Income allocated to the common stock is $140 ($280 / $1,000 * $500).

b. Step 2 is not relevant for the analysis of the present example because F.C. X is a C.F.C. for the full year.

c. Once Subpart F Income attributable to a class of stock is determined, further allocation to different shareholders holding that class of stock is done on a per share basis.[20]

   A's *pro rata* share of Subpart F Income allocable to the preferred stock is $90 (30 shares / 120 shares * $360). A's *pro rata* share of Subpart F Income allocable to the common stock is $84 (30 shares / 50 shares * $140). Therefore, total Subpart F Income includable in A's gross income for 2018 is $174 ($90 + $84). The remaining $90 of actual preferred dividends distributed ($180 - $90) will be treated as qualified dividends taxed at 20% for an individual, if all required conditions are met. If A were a U.S. corporation, then the remaining dividends would likely be exempt under Code §245A, if all of required conditions are satisfied.

d. Step 4 is not relevant since the E&P is not reduced by the amount of the actual dividends as, mentioned in Treas. Reg. §1.951-1(e)(3)(i).

When a C.F.C. Has More than One Class of Stock Outstanding and Two or More Classes of Stock Have Discretionary Distribution Rights

A class of stock is said to have discretionary distribution rights if the board of directors of a C.F.C has a discretionary power to declare dividends with respect to that class of stock without declaring dividends with respect to the other classes of stock. An example of a stock with discretionary distribution rights is participating preferred stock.

As discussed above, the general Subpart F Income allocation rule in circumstances involving more than one class of stock focuses on distributions attributable to a particular class of stock. If management has discretionary distribution rights, it may shift Subpart F Income to the shareholders who are indifferent to U.S. tax by granting distribution rights to the classes of stock owned by such shareholders. To circumvent this tax avoidance scheme, a separate set of allocation rules applies to classes with discretionary distribution rights. It requires the allocation of the C.F.C.'s E&P to the classes of stock with such rights on the basis of their fair market value. These rules can raise difficult valuation questions.

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[20] Treas. Reg. §1.951-1(e)(2).

The method of allocation of Subpart F Income when different classes of stock of a C.F.C. have discretionary distribution rights is a two-step process:[21]

1. The E&P of the C.F.C. is first allocated to any class of stock with a nondiscretionary right to a distribution, similar to the rule for corporations with more than one class of stock and only nondiscretionary distribution rights.

2. The remaining E&P is then allocated among the classes of stock with discretionary rights on the basis of the relative fair market value on the Hypothetical Distribution Date.

While discretionary dividends are declared and paid at the discretion of the board of directors and are therefore easy to track, the value of each particular class of stock is based on many variables, and for that reason, valuation requires sophisticated economic analysis. In some circumstances, substantial value may adhere to a particular class relative to the total value of all classes of stock. For example, a class of redeemable preferred shares having significant par value may be quite valuable for a corporation owning assets that are highly liquid. A U.S. Person that is a U.S. Shareholder under the new 10%-of-value threshold will be exposed to U.S. taxation under Subpart F. Under prior law, no such exposure existed. On the other hand, if the foreign corporation is considered a P.F.I.C. as well as a C.F.C., the C.F.C. rules should eliminate P.F.I.C. tax exposure – albeit at the cost of a purging election in certain circumstances.[22]

“A class of redeemable preferred shares having significant par value may be quite valuable for a corporation owning assets that are highly liquid.”

Further, when the value of each share of two or more classes of stock is substantially the same on the Hypothetical Distribution Date, the allocation of E&P to such classes is made as if such classes constituted one class of stock.[23] The regulations do not define the meaning of the phrase “substantially the same,” however, the Preamble to the Final Regulations provides that the value may be considered substantially the same even if the difference between them is more than *de minimis*.[24]

Example 6[25]

Facts:

F.C. X, a C.F.C., has outstanding 100 shares of Class A common stock, 100 shares of Class B common stock, and 10 shares of 5% nonparticipating, voting preferred stock with a par value of $50 each. The value of the Class A shares on the last day of F.C. X’s 2018 taxable year is $800. The value of the Class B shares on that date is $200. The Class A and Class B shareholders each are entitled to dividends when declared by the board of directors, and the board of directors may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock.

Corp D, Corp N, and Corp S are U.S. corporations and U.S. Shareholders of F.C. X. Corp D owns all of the Class A shares. Corp N owns all of the Class

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[21] Treas. Reg. §1.951-1(e)(3)(ii)(A).

[22] See generally Code §1297(d).

[23] Treas. Reg. §1.951-1(e)(3)(ii).

[24] Treas. Reg. §1.951-1(e)(6) Ex.6.

[25] Based on Treas. Reg. §1.951-1(e)(6), ex. 4. The example in this article has been modified to demonstrate the allocation of Subpart F Income in a situation where the Subpart F Income of the C.F.C. is not equal to its E&P.

B shares. Corp S owns all of the preferred shares. For 2018, F.C. X has $100 of E&P, of which $50 is attributable to Subpart F Income. In 2018, F.C. X distributes a nondiscretionary dividend of $25 to Corp S with respect to the preferred shares.

Analysis:

1. F.C. X has more than one class of stock: Class A common stock, Class B common stock, and 5% nonparticipating, voting preferred stock.

2. Two classes of stock (*i.e.*, Class A and Class B common stock) have discretionary distributions rights. This is because the board of directors have a discretionary right to declare dividends with respect to one class without declaring dividends with respect to the other. In comparison, Corp S is entitled to a fixed rate of dividend with regard to the preferred shares.

3. Since F.C. X has more than one stock and two or more classes of stock have discretionary distribution rights, the *pro rata* share of Subpart F Income of the U.S. Shareholders will be determined in accordance with Treas. Reg. §§1.951-1(e)(3)(i) and (ii).

4. The *pro rata* share of Subpart F Income allocable to the preferred stockholder (Corp S) will be determined in accordance with Treas. Reg. §1.951-1(e)(3)(i). Moreover, Treas. Reg. §1.951-1(e)(3)(ii) will not apply because Corp S does not have discretionary distribution rights. As mentioned above, the allocation of Subpart F Income under Treas. Reg. §1.951-1(e)(3)(i) is done using the following formula:

   ***Pro Rata* Share of Subpart F Income of Corp S Owning Preferred Stock of F.C. X:**

   $$\frac{\text{E\&P Distributable to Corp S in Hypothetical Distribution}}{\text{Total E\&P of F.C. X}} * \text{F.C. X's Subpart F Income}$$

   If $100 of E&P were distributed on December 31, 2018, $25 (5% of $500) would be distributable to Corp S with respect to its preferred shares. Therefore, applying the above formula, Subpart F Income includible in the gross income of Corp S is $12.50 ($25 / $100 x $50). The balance would be allocated to the actual distribution of E&P that can qualify for the dividends received deduction of Code §245A if the conditions of that provision are met.

5. The *pro rata* share of Subpart F Income allocable to Corp D's Class A common stock and Corp N's Class B common stock will be determined in accordance with Treas. Reg. §§1.951-1(e)(3)(i) and (ii). This is because Class A and Class B have discretionary distribution rights. The determination involves the following steps:

   a. Treas. Reg. §1.1951-1(e)(3)(ii) provides that the remaining E&P (after the fixed return) is allocated to different classes of stock

with discretionary distribution rights based on their fair market value on the Hypothetical Distribution Date.

b. The fair market value of each share of Class A common stock is $8 ($800 / 100 shares) and the fair market value of each share of Class B common stock is $2 ($200 / 100 shares). The value of each share of Class A and Class B stock is not the substantially same, and therefore, the two classes will not be treated as one class of stock.

c. The remaining E&P of $75 ($100 - $25) would be allocated with respect to Corp D's Class A shares and Corp N's Class B shares based on their fair market value on December 31, 2018.

d. Therefore, E&P Distributable to Corp D in the Hypothetical Distribution is $60 ($800 / $1000 * $75). Further, for the 2018 taxable year, Corp D's *pro rata* share of F.C. X's Subpart F Income will be determined in accordance with Treas. Reg. §1.951-1(e)(3)(i) using the following formula:

***Pro Rata* Share of Subpart F Income of Corp D Owning Class A Shares of Common Stock of F.C. X:**

$$\frac{\text{E\&P Distributable to Class A in Hypothetical Distribution}}{\text{Total E\&P of F.C. X}} * \text{F.C. X's Subpart F Income}$$

Thus, Corp D's *pro rata* share of F.C. X's Subpart F Income is $30 ($60 / $100 * $50).

e. Similarly, E&P allocable to Corp N in the Hypothetical Distribution is $15 ($200 / $1000 * $75). Further, for the 2018 taxable year, Corp N's *pro rata* share of F.C. X's Subpart F Income will be determined in accordance with Treas. Reg. §1.951-1(e)(3)(i) using the following formula:

***Pro Rata* Share of Subpart F Income of Corp N Owning Class B Shares of Common Stock of F.C. X:**

$$\frac{\text{E\&P Distributable to Class B in Hypothetical Distribution}}{\text{Total E\&P of F.C. X}} * \text{F.C. X's Subpart F Income}$$

Thus, Corp N's *pro rata* share of F.C. X's Subpart F Income is $7.50 ($15 / $100 * $50).

Example 7

Facts:

The facts are the same as in Example 6 except that the total value of Class A common stock is $500 and that of Class B common stock is $495.

Analysis:

The analysis remains the same as in Example 6, except for the fact that now Class A and Class B common stock will be treated as one class of stock in accordance with Treas. Reg. §1.951-1(e)(3)(ii). This is because the value of each share of Class A ($5 based on $500 / 100 shares) and Class B ($4.95 based on $495 / 100 shares) common stock is substantially the same.

1. As discussed above, when a C.F.C. has only one class of stock, the *pro rata* share of Subpart F Income is determined by allocating the C.F.C.'s E&P on a per share basis.[26] Therefore, E&P Distributable to Corp D in the Hypothetical Distribution is $37.50 (100 shares / 200 shares * $75).

2. Further, for the 2018 taxable year, Corp D's *pro rata* share of F.C. X's Subpart F Income will be determined in accordance with Treas. Reg. §1.951-1(e)(3)(i) using the following formula:

Pro Rata Share of Subpart F Income of Corp D Owning Class A Shares of Common Stock of F.C. X:

$$\frac{\text{E\&P Distributable to Class A in Hypothetical Distribution}}{\text{Total E\&P of F.C. X}} * \text{F.C. X's Subpart F Income}$$

Thus, Corp D's *pro rata* share of F.C. X's Subpart F Income is $18.75 ($37.50 / $100 * $50).

3. Similarly, E&P Distributable to Corp N in the Hypothetical Distribution is $37.50 (100 shares / 200 shares * $75). Further, for the 2018 taxable year, Corp N's *pro rata* share of F.C. X's Subpart F Income will be determined in accordance with Treas. Reg. §1.951-1(e)(3)(i) using the following formula:

Pro Rata Share of Subpart F Income of Corp N Owning Class B Shares of Common Stock of F.C. X:

$$\frac{\text{E\&P Distributable to Class B in Hypothetical Distribution}}{\text{Total E\&P of F.C. X}} * \text{F.C. X's Subpart F Income}$$

Thus, Corp N's *pro rata* share of F.C. X's Subpart F Income is $18.75 ($37.50 / $100 * $50).

The mathematical calculations of the Subpart F Income allocations may be confirmed by ensuring that the sum of the *pro rata* shares of Subpart F Income allocated among all U.S. Shareholders is equal to the total Subpart F Income of the C.F.C. However, this equation will hold true only if all the shareholders of the C.F.C. are U.S. Shareholders.

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26 Treas. Reg. §1.951-1(e)(2).

In Examples 6 and 7, F.C. X has three shareholders all of whom are U.S. Shareholders, and therefore, the above equation should be satisfied. In Example 6, the *pro rata* share of Subpart F Income of Corp D, Corp N, and Corp S are $30.00, $7.50, and $12.50 respectively, which add up to $50.00 – which is also F.C. X's Subpart F Income. In Example 7, the *pro rata* share of Subpart F Income of Corp D, Corp N, and Corp S are $18.75, $18.75, and $12.50 respectively, which also add up to $50.00 – which is F.C. X's Subpart F Income.

As mentioned above, E&P Distributable to a class of stock does not include the amount paid for its redemption. Additionally, the phrase "discretionary distribution rights" does not include the right to redeem shares of a class of stock even if a redemption is treated as a dividend under Code §302(d).[27] Thus, a class of redeemable shares of stock that do not have a right to receive dividends at the discretion of the management of the C.F.C. will not be allocated any E&P.

Example 8[28]

Facts:

F.C. X, a C.F.C. has the following outstanding stock:

- 40 shares of common stock
- 10 shares of redeemable 4% voting preferred stock with a par value of $50 per share

Pursuant to the terms, F.C. X has the right to redeem the preferred stock, in whole or in part, at any time. F.P., a foreign corporation, owns all of the preferred shares. Corp G, a domestic corporation wholly owned by F.P. and a U.S. Shareholder of F.C. X, owns all of the common shares. For 2018, F.C. X has $100 of E&P and $100 of Subpart F Income. F.C. X distributes as a dividend $20 to F.P. with respect to the preferred stock. F.C. X makes no other distributions during that year.

Analysis:

1. F.C. X has more than one class of stock, namely, common stock and preferred stock.
2. F.C. X has the right to redeem the preferred stock at any time in whole or in part. Pursuant to Treas. Reg. §1.951-1(e)(3)(ii)(B), rights to distributions in redemption of the preferred shares are not treated as discretionary distribution rights for the purpose of allocating E&P Distributable to the preferred stock in the Hypothetical Distribution. The class of preferred stock has only non-discretionary distribution rights because it is entitled to a 4% preferred dividend, annually.
3. Although, there are more than one class of stock (*i.e.*, common stock) that has been issued by F.C. X, both of which are outstanding, only one class has discretionary distributions rights. The other class (*i.e.*, preferred stock) has only non-discretionary distribution rights. This is

"A class of redeemable shares of stock that do not have a right to receive dividends at the discretion of the management of the C.F.C. will not be allocated any E&P."

27 Treas. Reg. §1.951-1(e)(3)(ii)(B).

28 Treas. Reg. §1.951-1(e)(6), ex. 7.

because, the right to redeem is not treated as a discretionary distribution right to a dividend.[29]

4. Therefore, Subpart F Income will be allocated under Treas. Reg. §1.951-1(e)(3)(i) in the following manner:

***Pro Rata* Share of Subpart F Income of Corp G Owning Common Stock of F.C. X:**
$\frac{\text{E\&P Distributable to Common Stock in Hypothetical Distribution}}{\text{Total E\&P of F.C. X}} * \text{F.C. X's Subpart F Income}$

a. If the total $100 of E&P were distributed on December 31, 2018, $20 (4% of $500) would be distributed with respect to F.P.'s preferred shares. The computation of its *pro rata* share of Subpart F Income is not necessary since F.P. is not a U.S. Shareholder and although F.P.'s shares are constructively owned by Corp G under Code §958(b), that attribution does not bring along an attribution of income to Corp G.

b. The remaining E&P would be distributed to Corp G's common shares. Accordingly, Corp G's *pro rata* share of F.C. X's Subpart F Income is $80 for taxable year 2018 ($80 / $100 * $100).

c. If the facts differed so that Subpart F Income of F.C. X were $50, then Corp G's *pro rata* share of F.C. X's Subpart F Income would have been $40 for taxable year 2018 ($80 / $100 * $50).

Certain Limitations and Restrictions on Distribution of Earnings Ignored in Determining the Amount of E&P Allocated to a Class of Stock

In determining the Hypothetical Distribution on the Hypothetical Distribution Date where more than one class of shares exist, the regulations generally prevent restrictions embodied in the corporate charter or an enforceable shareholders agreement from being taken into account.[30] An exception is provided for currency or other restrictions or limitations imposed under the laws of a foreign country [*e.g.*, blocked income as provided in Code §964(b)].

Examples of restrictions and limitations caught up by the general rule include:[31]

- An arrangement that restricts the ability of the C.F.C. to pay distributions to a class of shares owned by U.S. Shareholders until a condition or conditions are satisfied (*e.g.*, a class of stock must be redeemed before a second class can receive dividends)
- A loan agreement entered into by a C.F.C. that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied

29 Treas. Reg. §1.951-1(e)(4).

30 Treas. Reg. §1.951-1(e)(5)(i).

31 Treas. Reg. §1.951-1(e)(5)(iv).

- An arrangement that bases the ability of the C.F.C. to pay dividends to its shareholders on the C.F.C.'s financial condition

This treatment compares unfavorably to an operation that is carried on by a foreign corporation that is an eligible entity for purposes of the U.S. "check-the-box" rules. Examples of an eligible entity include a GmbH, S.A.R.L., limited company, or B.V.

If that entity were to make an election to be treated as a partnership for U.S. tax purposes, the waterfall of rights to distributions and accompanying income allocations would be recognized if they have substantial economic effect.

When a C.F.C. Has More than One Class of Stock Outstanding and One or More Classes of Stock Have both Non-Discretionary and Discretionary Distribution Rights

The method of allocating E&P differs slightly if a class of stock has mixed rights (*i.e.*, the holder of a particular class of stock is entitled to receive a fixed rate of return and also additional dividends over and above the fixed dividends at the discretion of the board of management of the C.F.C.). An example would be a class of preferred shares carrying a right to a fixed dividend and a right to participate in earnings. Where a class of stock exists with those rights, E&P is allocated in two steps. First, E&P is allocated to the nondiscretionary distribution rights in accordance with Treas. Reg. §1.951-1(e)(3)(i), which looks to the coupon rate. Second, the balance of the E&P is allocated to the discretionary distribution rights in accordance with Treas. Reg. §1.951-1(e)(3)(ii), which looks to fair market value. The stock's fair market value is taken into account only to the extent the value is solely attributable to the discretionary distribution rights. The latter value is equal to the portion of the shares value that remains after the value based on nondiscretionary rights are subtracted from total value. This again gives rise to a complex valuation question.

Example 9[32]

Facts:

F.C. X, a C.F.C., has issued the following two classes of stock, both of which are outstanding:

- There are 40 shares of participating, voting, preferred stock, all of which are owned throughout Year 1 by Corp D, a Delaware corporation. As the holder of all the issued and outstanding shares of this class of stock, Corp D is entitled to an annual dividend equal to 0.5% of F.C. X's E&P for the year for each share held. In addition, Corp D is entitled to such additional dividends declared by the board of directors.
- There are 200 shares of common stock, all of which are owned throughout the year by F.C. Z, a foreign corporation that is not a C.F.C. As the holder of this class of shares, F.C. Z is entitled only to dividends declared by the directors.

After the payment of the nondiscretionary dividends, the directors have discretion to declare and pay dividends on the participating portion of the preferred shares or the common shares.

[32] Treas. Reg. §1.951-1(e)(6), ex. 5.

On the last day of Year 1, the value of the preferred shares is $600, of which $100 is attributable to the discretionary distribution rights,[33] and the common shares are worth $400. For Year 1, F.C. X has $100 of E&P, all of which is attributable to Subpart F Income. Its only distribution to shareholders is the nondiscretionary dividend of $20 on the preferred shares ($100 x 0.5% x 40).

Analysis:

1. F.C. X has more than one class of stock: common and preferred stock.
2. As the sole holder of the preferred shares, Corp D is entitled to a fixed rate of return of 0.5% of F.C. X's E&P for each of the 40 shares held and is also entitled to participate in the annual profits of F.C. X at the discretion of the board of directors.
3. As the sole holder of the common stock, F.C. Z is entitled to receive dividends at the discretion of the board of management.
4. F.C. X has more than one class of stock and one class of stock has both discretionary and nondiscretionary distribution rights.
5. Therefore, Subpart F Income will be allocated to Corp D in accordance with Treas. Reg. §§1.951-1(e)(3)(i) and (iii).
   a. The $100 of E&P is allocated first to the preferred shares to cover the nondiscretionary distribution rights of $20.[34]
   b. The remaining $80 of E&P is allocated between the preferred and common shares in proportion to the value of the discretionary distribution rights of the preferred shares ($100) and the value of the common shares ($400).[35]
   c. Of this $80, the allocation to preferred shares is $16 ($100 / $500 * $80) and to common shares is $64 ($400 / $500 * $80).
   d. Corp D's *pro rata* share of F.C. X's Subpart F Income is therefore $36 ($20 + $16) with respect to the discretionary rights.

2018 PROPOSED REGULATIONS

In 2018, the I.R.S. issued proposed Treas. Reg. §1.951-1, which reflects a new approach in determining a U.S. Shareholder's *pro rata* share of Subpart F Income when the C.F.C. has multiple classes of stock. Some of the significant changes proposed under the regulations include the following:

- In lieu of prescribing a determination based on fair market value (as discussed above), the proposed regulations provide that the amount of E&P to be distributed with respect to multiple classes of stock will be based on the

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[33] In broad terms, the value would be determined working backward from the absolute amount of the preferred dividend and an arm's length interest rate that is appropriate for a junior security with F.C. X's credit rating.

[34] Treas. Reg. §§1.951-1(e)(3)(i), (iii).

[35] Treas. Reg. §1.951-1(e)(3)(iii).

distribution rights of each class of stock on the Hypothetical Distribution Date. The distribution rights of a class of stock are determined taking into account all relevant facts and circumstances related to the economic rights and interest in the current E&P of the corporation of each class, including the terms of the class of stock, any agreement among the shareholders, and where appropriate, the fair market value of the shares of stock.[36] The proposed regulations do not indicate any appropriate circumstances as to when the fair market value of the shares may be taken into account to determine E&P Distributable. Once the amount of E&P Distributable to the class is determined, it is then allocated *pro rata* to each share within the class.

- The total E&P of the C.F.C. (used in the denominator) is the greater of two amounts: (i) the current E&P of the C.F.C. as computed under the principles of Code §964 and (ii) the sum of Subpart F Income and C.F.C. tested income computed for G.I.L.T.I. purposes.[37] This provision will be applied to the taxable years of C.F.C.'s beginning after December 31, 2017.
- The proposed regulations retain the method of allocating Subpart F Income for a C.F.C. with one class of stock, providing that the C.F.C.'s E&P Distributable will be determined on a per share basis.
- The current treatment providing for disregarding redemptions, liquidations, and return of capital distributions for the purpose of determining E&P Distributable is retained under the proposed regulations.[38]
- The proposed regulations disregard any transaction or arrangement that is part of a plan that has a principal purpose of reducing a U.S. Shareholder's *pro rata* share of the Subpart F Income of a C.F.C.[39]

If and when finalized, the above provisions (except the provision regarding total E&P, which will take effect as mentioned) will be applied to taxable years of a U.S. Shareholder ending on or after October 3, 2018.

CONCLUSION

The enactment of the T.C.J.A. caused an uproar among U.S. Persons who invested in foreign tax structures by limiting their investments to nonvoting shares of foreign corporations. Under prior law, Subpart F did not result in the imposition of tax because the investors were not U.S. Shareholders. Now, however, Subpart F will accelerate the incidence of U.S. tax for a U.S. Person that (i) individually owns shares having 10% or more of the value of all shares of a foreign corporation when (ii) collectively all U.S. Shareholders own shares having more than 50% of the value or voting power or all shares of that foreign corporation. The foreign corporation will be a C.F.C., and the individual shareholder will be a U.S. Shareholder. As a result, values of all classes of shares of the C.F.C. must be determined annually in order to allocate the Subpart F Income to the shares held by the U.S. Shareholder. The simple days of looking to voting power are over. R.I.P.

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36 Prop. Treas. Reg. §1.951-1(e)(3).

37 Prop. Treas. Reg. §1.951-1(e)(1)(ii).

38 Prop. Treas. Reg. §1.951-1(e)(4)(i).

39 Prop. Treas. Reg. §1.951-1(e)(6).

MISSED OPPORTUNITIES – TAX COURT SHOWS NO MERCY FOR INDIRECT PARTNER

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Tags
Indirect Ownership
Partnership
Tax Matters Partner

DECISION

In a recent memorandum,[1] the Tax Court ruled that an indirect partner is not able to challenge the tax liability of a partnership after the period provided in Code §§6226(a) and (b) despite a lack of notification from the tax matters partner. In other words, under the facts at hand, the taxpayer in *Allen R. Davison III v. Commr.* missed the chance for pre-payment litigation over the merits of a tax assessment. The case highlights the necessity of timely raising any defense a taxpayer may have.

PETITIONS AND APPEALS

Pursuant to Code §§6226(a) and (b), within 90 days of the mailing of a final partnership administrative adjustment ("F.P.A.A."), a tax matters partner[2] may file a petition with the Tax Court or other referenced Federal court for readjustment of the partnership items. If the tax matters partner fails to file such a petition, any notice partner may file a petition for readjustment within 60 days after the 90-day period has closed.

In this case, no petition was ever filed. The two F.P.A.A.'s at issue therefore became binding and conclusive upon the taxpayer, allowing the I.R.S. to make the computational adjustments to his income.

In his reply brief, the taxpayer contended that he was not notified of these F.P.A.A.'s until after the statutory period for timely appealing the determinations had already passed. In response, the court analyzed Code §6223(a),[3] which states that the Commissioner must give partners notice of the beginning of administrative proceedings and the resulting F.P.A.A. However, the taxpayer in Davison was not a partner in either of the partnerships that were audited. Rather, he held an indirect interest in these entities through his interest in an intermediate partnership. The taxpayer did not argue, nor did the record reflect, that the I.R.S. was informed that the taxpayer was an indirect partner within the meaning of Code §6223(c)(3).

Under Code §6223(h)(2), the tax matters partner of the intermediate partnership was required to forward copies of the F.P.A.A. to the taxpayer. Furthermore, in any event:

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1 *Allen R. Davison III v. Commr.*, T.C. Memo. 2019-26 (4/3/19)

2 For a detailed discussion of the role of the tax matters partner, see "Corporate Matters: Partner Representative and the New Partnership Audit Regime," *Insights* 5, no. 2 (2018).

3 Code §6223, as applicable here, has since been amended. This reference and later references to Code §6223 refer to the section before it was amended by BBA sec. 1101(c), 129 Stat. at 627.

> The failure of a tax matters partner, a pass-thru partner, the representative of a notice group, or any other representative of a partner to provide any notice or perform any act . . . [such as an appeal to an F.P.A.A.] does not affect the applicability of any proceeding or adjustment . . . to such partner.[4]

Because the taxpayer indirectly held interests in two partnerships and Code §6223(c)(3) is of no avail here, the court ruled that the I.R.S. was not required to provide him an individual notice of the F.P.A.A.

Note that the Tax Court's review of an Appeals determination under Code §6330(c)(3) is limited to the issues that a taxpayer raises before Appeals.

In Davison, the court stated that if a taxpayer had an earlier opportunity to dispute a liability, the liability cannot be contested in a Collection Due Process or Equivalent Hearing or thereafter in the Tax Court. According to the court, the case law is clear. The taxpayer is precluded from challenging the existence or the amount of underlying income tax liabilities if there was opportunity to challenge the partnership items that were reflected on the two F.P.A.A.'s.

A SPECIAL CASE?

At first, it may seem that the I.R.S. was harsh in determining that the taxpayer missed his chance to contest the F.P.A.A. for the two partnerships he held indirectly through another partnership. However, it does not seem so harsh when the identity of the taxpayer is understood.

The taxpayer, Allen R. Davison III, was the son of Allen R. Davison II, who represented his son in this case. The father is a licensed C.P.A. and member of the Nebraska bar, who, in May 2010, was permanently barred from promoting a variety of tax fraud schemes. He was required by the Justice Department to provide a list of all clients from 2005 through 2010 and to continue doing so as long as he continued to provide tax advice.

The partnerships that were the subject of this case were most likely among the tax shelters crafted by the taxpayer's father. So, it is no surprise that the I.R.S. may have a particular interest in this case.

4 Sec. 6230(f); *Kimball v. Commr.*, T.C. Memo. 2008-78, slip op. at 9.

CORPORATE MATTERS: DELAWARE LAW ALLOWS L.L.C. DIVISIONS

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Tags
Corporate Law
Delaware
Division
L.L.C.

INTRODUCTION

In 2018, Delaware amended its limited liability company ("L.L.C.") act to add Section 18-217, which enables an L.L.C. to divide into two or more newly formed L.L.C.'s, with the dividing company either continuing or terminating its existence.

A division is something to consider in the context of a business divorce when the members of an L.L.C. cannot agree on how to proceed jointly. Instead of fighting or terminating the L.L.C., they can agree to proceed separately by dividing the L.L.C. into multiple entities in a straightforward way. For example, in a fact pattern in which an L.L.C. owning two distinct assets of relatively similar value is inherited by two siblings who no longer get on well with each other, a division allows ownership of the assets to be split easily, with each family member receiving a separate asset in a separate single-member L.L.C. This split would end the partnership and the headaches of dual management. In addition, a division would not require a "buyout" by one partner or a sale, but instead would encompass one L.L.C. splitting into two, where each member walks away from the other with a portion of the own property.

In previous Corporate Matters, we have described the general flexibility of Delaware law when it comes to matters of governance of L.L.C.'s. The amendment to the Delaware Limited Liability Company Act (the "Act") allowing for division of an L.L.C. provides members with significant flexibility in managing and disposing of the assets, liabilities, rights, and duties of the company.

PLAN OF DIVISION

The new law became effective August 1, 2018. Under its provisions, any Delaware L.L.C. may adopt a plan of division and divide into two or more Delaware L.L.C.'s. The plan of division must include the following provisions:

- The terms and conditions of the division, including the conversion or exchange of the L.L.C. interests of the dividing company into or for L.L.C. interests or other securities of two or more resulting L.L.C.'s and the allocation of assets, properties, rights, series, debts, liabilities, and duties of the dividing L.L.C. among the resulting L.L.C.'s
- The name of each resulting L.L.C. and, the name of the surviving company if the dividing company will survive the division[1]

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[1] Section 18-217(d) of the Act states that unless otherwise provided in a plan of division, the division of a domestic L.L.C. shall not require such L.L.C. to wind up its affairs or pay its liabilities and distribute its assets, and the division shall not constitute a dissolution of such L.L.C. Note, however, Section 18-217(j) of

- The name and business address of a division contact that has custody of a copy of the plan of division
- Any other matters that the dividing company determines to include

Pursuant to the new law, ownership of the dividing L.L.C.'s assets vests by operation of law in the resulting L.L.C.'s to which allocated. The liability for L.L.C. debts vests similarly by allocation agreed to in the plan of division. Vesting of assets by operation of law provides a potential benefit of avoiding transfer restrictions that might be triggered in a different type of transaction, as well as avoiding cumbersome documentation requirements associated with transferring title to assets.

The plan of division is not required to be filed with the Delaware Secretary of State or otherwise be publicly available. The only filing required with the Secretary of State in order to effectuate the division is the certificate of division.

"Any Delaware L.L.C. may adopt a plan of division and divide into two or more Delaware L.L.C.'s."

The division contact is required to keep a copy of the plan of division for at least six years after the effective date. The division contact is responsible for keeping records of and updating important information regarding the new and resulting L.L.C.'s.

APPROVAL

In the absence of specification in the L.L.C. agreement, as will be the case initially for nearly all entities due to the law's recent enactment, Section 18-217 provides that a plan of division must be adopted in the same manner as a plan of merger, if the manner for adopting a plan of merger is specified in the L.L.C. agreement.

In the absence of a specific provision in the L.L.C. agreement with respect to adoption of plans of mergers, a plan of division must be adopted by 50% or more of the members of the dividing L.L.C.

In addition, an L.L.C. agreement may provide that an L.L.C. will not have the power to divide, in which case this option is not available to members in the absence of a revision to the L.L.C. agreement.

CREDITOR PROTECTION

The statute provides protection for creditors of the dividing company. If the plan of division does not allocate any liability or obligation to a resulting entity, all L.L.C.'s remaining after the division are jointly and severally liable for the obligation. Joint and several liability also arises if a court determines that the allocation of assets or liabilities constituted a fraudulent transfer with regard to creditors.

In addition, if an L.L.C. is formed prior to August 1, 2018, and is a party to a written agreement entered into prior to that date which contains restrictions, conditions, or prohibitions on mergers, consolidations, or asset transfers, such restrictions are deemed to apply to a division as if it were a merger, consolidation, or asset transfer. Parties that enter into agreements with L.L.C.'s on or after August 1, 2018, wishing to restrict divisions must specifically provide for such restrictions in their agreements.

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the Act states that a certificate of division shall act as a certificate of cancellation for a dividing company that is not a surviving company.

Creditor protection is furthered by obligations imposed on the division contact. It must retain records for six years following the division regarding the name and address of the resulting L.L.C. to which such creditor's claim was allocated for and must make that information available during that period.

All debts, liabilities, and duties of the dividing company that have been allocated to a resulting L.L.C. pursuant to a plan of division remain vested in that L.L.C. They are not considered to have been assigned or transferred to such division company for any purpose of the laws of the State of Delaware. Assignment or transfer restriction provisions in contracts should be broad enough to capture assignments or transfers by operation of law, such as conversions and mergers (including divisive mergers).

APPLICATION TO SERIES L.L.C.'S

The procedure set forth in Section 18-217 of the Act is well suited for use in connection with a series L.L.C. Because meticulous records within a series L.L.C. are needed for business reasons – *i.e.*, the allocation of assets and liabilities among various silos within the series L.L.C. – the allocation of assets and liabilities to resulting companies in a division should be a relatively straight forward task.

FEDERAL INCOME TAXATION

The division of an L.L.C. can result in unexpected and potentially adverse tax consequences. Generally, an L.L.C. is treated as a partnership for tax purposes when it has two or more members and has taken no action to be taxed as a corporation. The tax consequences for the members of the dividing L.L.C. will depend, in part, on the number of members in each divided L.L.C. Special tax regulations promulgated under Code §708 will apply when an L.L.C. divides into two or more L.L.C.'s where each is owned by at least two members of the former L.L.C. Under these rules, a resulting L.L.C. may be treated as either a continuing or a new partnership, with different tax consequences applicable to each.

As indicated above, it is possible for a L.L.C. to elect to be taxed as a corporation. Hence, the rules of Subchapter C of the Code will be applicable to the division of an L.L.C. having made that type of election for Federal income tax purposes. In that set of circumstances, the division of an L.L.C. most likely results in tax at both the corporate and member levels unless the division is structured to qualify as a divisive D-reorganization or a tax-free split-off, each of which contains its own set of complexities.

NEW YORK STATE RENEWS THE THREE-YEAR CLAWBACK FOR GIFTS

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Estate and Gift Tax
New York
State and Local Tax

Generally, Federal estate and gift taxes are imposed on a person's right to transfer property to another person during life or upon death. State rules may differ from the Federal regime, imposing either an estate tax, inheritance tax, or gift tax or some combination of these taxes.

New York State limits its taxation to an estate tax on the transfer of property at the time of death. There is no gift or inheritance tax. But as of April 1, 2014, gifts made by a N.Y. resident between April 1, 2014, and December 31, 2018, were "clawed back" (added back) to the giver's New York State taxable estate if the gifts were made within three years of their death. A gift was not added back if it was made (i) when the decedent was not a N.Y. resident, (ii) before April 1, 2014, or (iii) on or after January 1, 2019.

The clawback was designed to prevent wealthy New Yorkers from making gifts shortly before their deaths to avoid New York estate tax while still taking advantage of the high Federal estate and gift tax exclusion.

The rule was set to expire on January 1, 2019 – the same time the state estate tax would equal the anticipated (pre-2017 tax reform) Federal estate tax exemption, thus eliminating the need for the clawback rule. But, Federal tax reform doubled the Federal exclusion amount (to roughly twice the N.Y. exemption), creating the need, once again, to extend the clawback to prevent revenue losses from deathbed gifts.

On April 12, 2019, as part of the New York Fiscal Year 2020 Budget, New York State extended the three-year clawback on gifts through December 31, 2025, after which the Federal tax exclusion amount is expected to align with the New York exemption.

The renewed clawback does not apply to the gifts made at certain times and under certain circumstances:

- When the decedent was not a N.Y. resident
- Before April 1, 2014
- Between January 1, 2019, and January 15, 2019 (the brief period in 2019 prior to the announcement of the Governor's executive budget on January 15, 2019)
- With respect to a gift of real or tangible property located outside N.Y.
- On or after January 1, 2026

If none of these exceptions apply, gifts made by a N.Y. resident within three years of their death will be added back to the giver's New York State taxable estate.

NEW YORK STATE SAYS NO TO ANNUAL PIED-À-TERRE TAX, YES TO INCREASED REAL ESTATE TRANSFER TAXES

Author
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Tags
New York
Real Estate Transfer Tax
Mansion Tax

New York City's public transportation system is old and in desperate need of significant renovation. The city has also attracted many high net worth individuals who purchase New York City residences but do not have significant presence to cause them to pay New York City income taxes. As part of New York State's annual budget process, serious consideration was given to an annual *pied-à-terre* tax on homes worth $5 million or more that do not serve as the buyer's primary residence.

According to the New York Times, in 2017, New York City had 75,000 *pieds-à-terre* – up from 55,000 such units in 2014, according to the New York City Housing and Vacancy Survey. The share of vacant apartments that are classified as *pieds-à-terre* has held steady during that time at about 30%.[1]

Bloomberg reports that New York's powerful real estate industry succeeded in killing the *pied-à-terre* tax, which some considered "class warfare" against the rich and a measure likely to hurt already-slowing luxury sales.[2]

In its place were increased real estate transfer and mansion taxes, effective for sales on or after July 1, 2019. Note, however, that if a written purchase and sale agreement exists and was entered into on or before April 1, 2019, the transaction will still be taxed at the lower rates even if the closing occurs on or after July 1, 2019.

New York State transfer taxes (currently .4%) will increase by .25% (to .65%) for residential sales in excess of $3 million. New York City transfer taxes remain unchanged.

The "old" mansion tax of 1% for residential sales of $1 million or higher remains. However, there is a "new" additional graduated mansion tax ranging from .25% to 2.9%:

Sales Price	Additional Mansion Tax
$2 to <$3 million	.25%
$3 to <$5 million	.50%
$5 to <$10 million	1.25%
$10 to <$15 million	2.25%

1 "Lawmakers Support 'Pied-à-Terre' Tax on Multimillion-Dollar Second Homes," *The New York Times*, March 11, 2019.

2 "NYC Brokers Relieved as Mansion Tax Replaces a Pied-a-Terre Levy," *Bloomberg*, April 1, 2019.

Sales Price	Additional Mansion Tax
$15 to <$20 million	2.5%
$20 to <$25 million	2.75%
$25 million+	2.9%

By way of example, as reported in The Real Deal, the recent purchase of a condominium for $238 million would have resulted in $14.3 million in taxes under the new system, as opposed to $6.9 million under the old system.[3]

[3] "This Calculator Shows How the New Mansion, Transfer Taxes Work," *The Real Deal*, April 02, 2019.

About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

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Insights, the monthly tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

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