INTRODUCTION

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GLOBAL TAX PLANNING IN A PRE-2018 WORLD

Prior to 2018, widely-used tax plans of U.S.-based multinational groups were designed to achieve three basic goals in connection with European operations: (i) the reduction of European taxes as European profits were generated, (ii) the integration of European tax plans with U.S. tax concepts to prevent Subpart F from applying to intercompany transactions in Europe, and (iii) the reduction of withholding taxes and U.S. tax under Subpart F as profits were distributed through a chain of European companies and then to the global parent in the U.S.

Reduction of Taxes in Europe

The first goal – the reduction of European taxation on operating profits – often entailed the deconstruction of a business into various affiliated companies, which can be illustrated as follows:

- Group equity for European operations was placed in a holding company that served as an *entrepôt* to Europe.
- Tangible operating assets related to manufacturing or sales were owned by a second company or companies where the facilities or markets were located.
- Financing was provided by a third company where rulings or legislation were favorable.
- Intangible property was owned by a fourth company qualifying as an innovation box company.

If the roadmap was carefully followed, European taxes on operations could be driven down in ways that did not result in immediate U.S. taxation under Subpart F. A simplified version of the plan that was widely used by U.S.-based multinational groups involved the following steps:

- Form an Irish controlled foreign corporation ("TOPCO") that is managed and controlled in Bermuda.
- Have TOPCO enter into a qualified cost sharing agreement with its U.S. parent providing for the emigration of intangible property to TOPCO for exploitation outside the U.S. at an acceptable buy-in payment that could be paid overtime.
- Have TOPCO form a Dutch subsidiary ("DCO") to serve as a licensing company, and an Irish subsidiary ("OPCO") to carry on active business operations.

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- Make check-the-box elections for DCO and OPCO so that both are treated as branches of TOPCO.
- Have TOPCO license the rights previously obtained under the qualified cost sharing agreement to DCO and have DCO enter a comparable license agreement with OPCO.

The use of check-the-box entities within Europe eliminated Subpart F income from being recognized in the U.S. A functionally comparable arrangement could be obtained for intercompany loans where such loans were required for capital investments. The qualified cost sharing arrangement eliminated the application of Code §367, which otherwise would mandate ongoing income inclusions for the U.S. parent as if it sold the intangible property pursuant to a deferred payment arrangement with the sales price being contingent on future revenue. Any intercompany dividends paid within the group headed by TOPCO were ignored for Subpart F purposes because of the check-the-box elections made by all of TOPCO's subsidiaries. At the same time, deferred taxes were not reported as current period expenses on financial statements prepared by the U.S. parent provided the underlying earnings were permanently invested abroad.

Meanwhile, earnings were funneled up to the European group equity holder and recycled for further expansion within the European group. Intragroup payments typically did not attract withholding tax under the Parent-Subsidiary Directive ("P.S.D.") or the Interest and Royalty Directive ("I.R.D.") of the European Commission ("E.C.").

For other U.S.-based groups – primarily, those companies that regularly received dividend payments from European operations – the use of a holding company could reduce foreign withholding taxes claimed as foreign tax credits by the U.S. parent in many instances. This was true especially where the U.S. did not have an income tax treaty in force with a particular country or the treaty provided for relatively high withholding tax rates on dividends. Nonetheless, sophisticated planning was often required to take full advantage of the foreign tax credit because of various limitations and roadblocks that existed under U.S. tax law.

Foreign Tax Credit Planning in the U.S.

Although the foreign tax credit has often been described as a "dollar-for-dollar reduction of U.S. tax" when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality has been quite different. Only taxes that were imposed on items of "foreign-source taxable income" could be claimed as credits.[1] This rule, known as "the foreign tax credit limitation," was intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S.-taxable income. The U.S., as with most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income.

The foreign tax credit limitation was structured to prevent so-called "cross crediting," under which high taxes on operating income could be used to offset U.S. tax on lightly taxed investment income. For many years, the foreign tax credit limitation was applied separately with regard to eight different categories, or baskets, of income designed to prevent the absorption of excess foreign tax credits by low-tax foreign-source income. In substance, this eviscerated the benefit of the foreign tax

[1] Section 904(a) of the Internal Revenue Code of 1986, as amended from time to time ("Code").

credit when looked at on an overall basis. The problem was eased when the number of foreign tax credit baskets was reduced from eight to two: passive and general.

Additionally, the foreign tax credit was reduced for dividends received by U.S. citizens and resident individuals from foreign corporations that, in the hands of the recipient, benefited from reduced rates of tax in the U.S. A portion of foreign dividends received by U.S. individuals that qualify for the 0%, 15%, or 20% tax rate under Code §1(h)(11)(B)(i) was removed from the numerator and denominator of the foreign tax credit limitation to reflect the reduced U.S. tax rate imposed on those items.[2] This treatment reduced the foreign tax credit limitation when a U.S. citizen or resident individual received both qualifying dividends from a foreign corporation – subject to low tax in the U.S. – and other items of foreign-source income within the same basket – subject to much higher ordinary tax rates. Another reduction in foreign source gains applied when U.S. source losses reduced foreign source gains. The goal of the provision was to eliminate a double benefit for the taxpayer regarding foreign source gains in that fact pattern. The first benefit was use of a domestic loss to reduce the foreign gain when computing taxable income. The second benefit was the elimination of U.S. tax due by reason of the foreign tax credit.[3]

"U.S. income tax regulations required expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income."

As a result of all the foregoing rules, a U.S.-based group was required to determine (i) the portion of its overall taxable income that was derived from foreign sources, (ii) the portion derived in each "foreign tax credit basket," and (iii) the portion derived from sources in the U.S. This was not an easy task, and in some respects, the rules did not achieve an equitable result from management's viewpoint.

Allocation and Apportionment Rules for Expenses

U.S. income tax regulations required expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.[4] The allocation and apportionment procedures set forth in the regulations were exhaustive and tended to maximize the apportionment of expenses to foreign-source income. For example, all interest expense of the U.S. parent corporation and the U.S. members of its affiliated group were allocated and apportioned under a set of rules that allocated interest expense on an asset-based basis to all income of the group.[5] Direct tracing of interest expense to income derived from a particular asset was permitted in only limited circumstances[6] involving qualified nonrecourse indebtedness,[7] certain integrated financial transactions,[8] and certain related controlled foreign corporation ("C.F.C.") indebtedness.[9] Research and development expenses, stewardship expenses, charitable deductions, and state franchise taxes needed to be allocated and apportioned among the various classes of income reported on a tax return. These rules tended to reduce the amount of foreign-source taxable income in a particular category, and in some cases, eliminated all income in that category altogether.

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2 Code §§1(h)(11)(C)(iv) and 904(b)(2)(B).

3 Code §904(b)(2)(A).

4 Treas. Reg. §§1.861-8 through 17.

5 Treas. Reg. §§1.861-9T(f)(1) and (g).

6 Treas. Reg. §1.861-10T(a).

7 Treas. Reg. §1.861-10T(b).

8 Treas. Reg. §1.861-10T(c).

9 Treas. Reg. §1.861-10T(e).

The problem was worsened by carryovers of overall foreign loss accounts.[10] These were "off-book" accounts that arose when expenses incurred in a particular prior year that were allocable and apportionable to foreign-source income exceeded the amount of foreign-source gross income for the year. Where that occurred, the loss was carried over to future years and reduced the foreign-source taxable income of the subsequent year when computing the foreign tax credit limitation.

Self-Help Through Inversion Transactions

The pressure that was placed on the full use of the foreign tax credit by U.S.-based groups resulted in several public companies undergoing inversion transactions. In these transactions, shares of the U.S. parent company held by the public were exchanged for comparable shares of a newly formed offshore company to which foreign subsidiaries were eventually transferred. While the share exchange and the transfer of assets arguably were taxable events, the identity of the shareholder group (*i.e.*, foreign persons or pension plans) or the market value of the shares (*i.e.*, shares trading at relatively low values) often eliminated actual tax exposure in the U.S. Thereafter, the foreign subsidiaries were owned directly or indirectly by a foreign parent corporation organized in a tax-favored jurisdiction and the foreign tax credit problems disappeared.

This form of "self-help" was attacked in the anti-inversion rules of Code §7874. In some circumstances, Code §7874 imposes tax on inversion gains that cannot be reduced by credits or net operating loss carryforwards.[11] This occurs in the case described below:

- A foreign corporation acquires substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership.
- After the acquisition, at least 60% of the stock of the acquiring entity is held by either (i) former shareholders of the domestic corporation by reason of their holding stock in the domestic corporation or (ii) former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership.
- After the acquisition, the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity was created or organized when compared to the total business activities of the expanded affiliated group.[12]

In other circumstances, the acquiring entity is considered to be a domestic corporation for purposes of U.S. tax law. This occurs when the former shareholders or partners own at least 80% of the stock of the acquiring entity after the transaction.[13]

Broad regulatory authority has been granted to the I.R.S. to carry out the purposes of Code §7874. By 2017, 12 regulations were issued to address situations that appear to be beyond a literal reading of the statute, but are nonetheless deemed to

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[10] Code §904(f).

[11] Code §7874(a)(1).

[12] Code §7874(a)(2)(B).

[13] Code §7878(b).

be abusive by the I.R.S. Abuses that have been addressed by the I.R.S. include the following examples:

- Identifying circumstances where the minimum stock ownership requirement ostensibly is not met, but the foreign acquiring corporation holds a significant amount of passive assets, suggesting the existence of an asset-stuffing transaction intended to avoid a trigger for application of the anti-inversion provisions.[14]
- Combining prior acquisitions of U.S. targets by the foreign acquirer when used to bolster a much larger single acquisition of a target.[15]
- Combining prior acquisitions of foreign targets by the foreign acquirer when used to bolster a much larger single acquisition of a target.[16]
- Addressing certain transfers of stock of a foreign acquiring corporation, through a spin-off or otherwise, following an acquisition.
- Identifying the occurrence of certain distributions that are not made in the ordinary course of businesses by the U.S. entity, suggesting an intent to avoid a trigger for application of the anti-inversion provisions.[17]
- Identifying the acquisition by a C.F.C. of obligations of or equity investments in the new foreign parent corporation or certain foreign affiliates suggesting an intent to avoid taxable investments in U.S. property when such investments were taxable in the hands of a U.S. parent corporation.[18]
- Addressing the investment of pre-inversion earnings and profits of a C.F.C. through a post-inversion transaction that terminates the C.F.C. status of foreign subsidiaries or substantially dilutes a U.S. shareholder's interest in those earnings and profits.[19]
- Related-party stock sales subject to Code §304 (which converts a stock sale of controlled stock into a dividend payment) that are intended to remove untaxed foreign earnings and profits of a C.F.C.[20]

In 2016, the Treasury Department adopted updates to the U.S. Model Income Tax Convention (the "2016 U.S. Model"), which serves as the basic document that the U.S. submits when negotiating an income tax treaty. The draft provisions propose, *inter alia*, to reduce the tax benefits that may be enjoyed by an expatriated group

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14 Treas. Reg. §1.7874-7.

15 Treas. Reg. §1.7874-8.

16 Treas. Reg. §1.7874-9.

17 Treas. Reg. §1.7874-10.

18 Treas. Reg. §1.7874-11. The adoption of Code §245A eliminates the taxable event that otherwise exists for an investment in U.S. property in the context of a U.S. corporation owning 10% or more of the shares of a foreign corporation. See Treas. Reg. §1.956-1(a)(2).

19 Treas. Reg. §1.7874-12T.

20 Treas. Reg. §1.304-7T.

by imposing full withholding taxes on key payments such as dividends,[21] interest,[22] and royalties[23] made to connected persons that are residents of a treaty country by "expatriated entities" as defined under the Code. This treatment lasts for ten years and goes to the heart of the bargain between the U.S. and its treaty partners where the full U.S. withholding tax reduces the tax in the country of the recipient or the dividend is not taxable in the treaty partner country under a participation exemption.

GLOBAL TAX PLANNING IN A POST-2017 WORLD

The year 2017 sounded the death knell for cross-border tax planning carried on in the old-fashioned way.

By the end of 2017, too many barriers were in place to continue on with established planning strategies. First in line were the actions taken by the Organization for Economic Cooperation and Development ("O.E.C.D.") to curtail base erosion and profit shifting through adoption of the B.E.P.S. Project. Second, a never-ending package of directives issued by the European Commission and proposals by the European Parliament were designed to attack various tax plans in various ways, including all of the following measures:

- The Anti-Tax Abuse Directives ("A.T.A.D. 1," "A.T.A.D. 2," and most recently A.T.A.D. 3")
- The disclosure and dissemination of tax rulings
- The institution of ownership registers that will disclose the ultimate beneficial ownership of entities
- The mandatory reporting of aggressive tax planning under Council Directive (E.U.) 2018/822 amending Directive 2011/16/E.U. ("D.A.C.6")
- Limitations placed on the P.S.D. and the I.R.D. to block their application within a European group owned by a non-European parent company

At the same time, tax plans that were previously approved by tax administrations were characterized as a form of unlawful State Aid, triggering severe repayment obligations from benefiting companies.

European Attacks on Cross-Border Holding Companies and Tax Planning

Attacks on tax planning for cross-border holding companies have taken three approaches. The first is based on economic substance. The second is based on E.C. Directives. The third is based on transposition of the B.E.P.S. Actions into national law throughout Europe.

Attacks Based on Economic Substance

Tax benefits claimed by holding companies in Europe are now regularly challenged by the tax authorities of European countries in which companies making payment are resident. The challenges are directed at the substance of the holding company.

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21 Paragraph 5 of Article 10 (Dividends) of the 2016 U.S. Model.

22 *Id.*, ¶2(d) of Article 11 (Interest).

23 *Id.*, ¶2 of Article 12 (Royalties).

Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management involved in day-to-day decision-making.[24] In some instances, the capital structure of the holding company is queried. Most recently, the European Commission published a proposal for a Directive laying down rules to prevent the misuse of shell entities for improper tax purposes.[25]

For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than just tax residence in a particular country – it should conduct group functions in that country and be ready to provide evidence of the activities performed. These challenges within Europe should be compared with the approach to substance that is found in the limitation on benefits articles of U.S. income tax treaties. Objective standards are typically provided under which substance is judged to exist. In addition, ongoing business activities of a group member can be attributed to related parties. In particular, the active trade or business provision of most limitation on benefits articles allows intermediary holding companies to be viewed as active participants in a business if they own at least 50% of a subsidiary or partnership that has active business operations. These provisions eliminate intra-European challenges of tax authorities and may incentivize direct investment.

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Attacks Based on the B.E.P.S. Action Plan

Substance is also a key concern in the Final B.E.P.S. Package for Reform of the International Tax System to Tackle Tax Avoidance published by the O.E.C.D. The reports were commissioned by the G-20 and reflect findings that a disparity often exists between (i) the location of actual business activities and investment and (ii) the jurisdiction where the resulting profits are reported for tax purposes.

The reports set out how current cross-border taxation rules may create B.E.P.S. opportunities, thereby resulting in a reduction of the share of profits associated with substantive operations. They also emphasize how changes in global business practices are ahead of current international tax standards, with a special focus on intangibles and the digital economy. The reports identify (i) a need for increased transparency on the effective tax rates of multinational enterprises and (ii) the existence of key pressure areas as far as B.E.P.S. is concerned. These include the following key areas:

- International mismatches in entity and instrument characterization
- The application of treaty concepts to profits derived from the delivery of digital goods and services
- The tax treatment of related party debt-financing

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[24] A series of cases decided by the Court of Justice of the European Union ("C.J.E.U.") reflect the approach of the U.S. Tax Court in *Aiken Industries, Inc. v. Commr.*, 56 T.C. 925 (1971), and the I.R.S. in Rev. Rul 84-152 and Rev. Rul. 84-153 and ultimately Treas. Reg. §1.881-3. See *N Luxembourg 1 v. Skatteministeriet,* Joined Cases C-115, C-118, C-119 & C-299/16, [2019] ECLI:EU:C:2019:134; *Skatteministeriet v. T Danmark und Y Denmark Aps,* Joined Cases C-116/16 & C-117/16, [2019] ECLI:EU:C:2019:135.

[25] The Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/E.U. The proposal was issued on December 22, 2021.

- Captive insurance and other intra-group financial transactions
- Certain aspects of generally recognized transfer pricing rules
- The effectiveness of anti-avoidance measures
- The availability of harmful preferential regimes

The reports adopt a set of comprehensive, global, internationally coordinated action plans to effectively address the identified problem areas. The O.E.C.D. governments are particularly committed to the development of proposals to implement this action plan. Many U.S.-based multinational groups fear that the proposals will overturn arm's length principles that have been recognized internationally for many years. Their fears have been justified.

In 2021, the O.E.C.D. proposed Pillar 1 and Pillar 2. According to the O.E.C.D., Pillar 1 reallocates the profits of about 100 of the world's largest and most profitable multinational enterprises to market jurisdictions. For a targeted company, Pillar 1 expands the taxing rights of market jurisdictions to collect tax from the targeted enterprise, regardless of physical presence. Not covered by Pillar 1 are companies in the extractives sector, such as oil, gas, and mining companies. Also excluded are regulated companies operating in the financial services sector.

Pillar 2 is designed to ensure that a multinational enterprise pays a minimum level of tax, regardless of the location of its headquarters or the jurisdictions in which it operates. Pillar 2 is thought to target approximately 2,000 multinational corporations and is expected to raise about $150 billion in additional global tax revenue annually. Consequently, those persons who invest directly or indirectly in companies that are targeted will be adversely affected. Pillar 2 establishes a global minimum effective tax rate of 15%. It applies to multinational groups with consolidated group revenue of at least €750 million. Countries may elect to adopt a lower threshold for application. Under the Pillar 2 income inclusion rule ("I.I.R."), a "top-up" tax to the 15% global minimum rate is imposed on the parent of the group by its country of residence if a member tries to shift profits to low-tax or no-tax jurisdictions. If the tax is not collected by the ultimate parent in a chain of ownership, the jurisdiction of residence of the next lower company in the chain may impose the tax, and so on until the I.I.R. amount is fully collected. Pillar 2 also includes an under-taxed payments rule ("U.T.P.R."), under which a deduction for undertaxed cross-border payments is disallowed for the company making the payment. Alternatively, that country may impose a withholding tax on the payment. Note that a payment to a company that triggers the application of the I.I.R. for its ultimate parent does not prevent the U.T.P.R. rule from applying in the jurisdiction of the company making the payment.

While the B.E.P.S. Reports have no legal authority, they reflect a political consensus in Europe and elsewhere regarding steps to be taken to shut down transactions that are perceived to be abusive. Consequently, the B.E.P.S. Reports must be considered before setting up a foreign holding company in Europe. To illustrate, the Council of Economic and Finance Ministers ("E.C.O.F.I.N.") has recommended changes in the P.S.D. designed to eliminate the exemption enjoyed by parent companies for dividends paid by subsidiaries when the subsidiary claims a deduction for the payment. E.U. Member States implemented the change to the P.S.D. in 2016.[26]

[26] See also the Danish Cases discussed at note 24, where the C.J.E.U. adopted B.E.P.S. concepts as part of European Law.

The B.E.P.S. Reports reflect a view that is now accepted by tax authorities throughout Europe. Taxation should not be viewed as an expense. Rather, it reflects a profit-sharing arrangement between governments and businesses, akin to the interest of limited partners in a limited partnership. The multinational enterprise is looked at as if it is the general partner and governments are looked at as limited partners. Viewed in this light, schemes with no substance cannot be allowed to deprive the governments of their "profit share." Such a scheme does not reflect good tax planning; rather, it is viewed as theft, plain and simple. In what is known as the Cum-Ex scandal,[27] Denmark is actively pursuing civil claims against facilitators of a specific tax refund arrangement that took advantage of flawed withholding tax rules for dividend payments by Danish companies. The defendants are individuals, professional firms, and advisers, based mostly in the U.S. and the U.K. It is reported that Denmark has budgeted $380 million for legal costs to purse its targets.

Attacks Based on State Aid

Cross-border tax planning within the E.U. has faced challenges based on concepts of State Aid, transparency, and the Common Reporting Standard. Until recently, tax planning was not viewed to be an item of unfair State Aid violating basic rules of the E.U. That has changed. In its place is a mechanism calling for information reporting designed to promote pan-European information exchange, both as to bank balances and "sweetheart" tax rulings.

Following the O.E.C.D. B.E.P.S. Reports, the European Commission introduced an anti-tax avoidance directive (*i.e.*, the A.T.A.D. 1). It was adopted on June 20, 2016, and contains anti-tax avoidance rules in five specific fields:

- Exit taxation
- Interest deduction limitation
- C.F.C. rules
- The general anti-abuse rule ("G.A.A.R.")
- Hybrid mismatches

The rules are in addition to the changes to the P.S.D. (regarding G.A.A.R. and anti-hybrid financing rules) and may be followed by a relaunched proposal on the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B.").

On February 21, 2017, the E.U. Member States agreed on an amendment to the A.T.A.D. 1 (*i.e.*, the A.T.A.D. 2), which provides detailed rules targeting various hybrid mismatches between Member States and countries outside the E.U. The following mismatches are included:

- Hybrid financial instrument mismatches
- Hybrid entity mismatches

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[27] See Sunita Doobay and Stanley C. Ruchelman, *Adventures in Cross-Border Tax Collection: Revenue Rule vs. Cum-Ex Litigation,* Tax Notes International, April 18, 2022, cover and pp. 329-372 and Tax Notes Federal, April 18, 2022, pp. 359- 403.

- Reverse hybrid mismatches
- Hybrid transfers
- Hybrid permanent establishment mismatches
- Dual resident mismatches

Revisions to U.S. Tax Rules Affecting Global Business

If these were not sufficient impediments to old-fashioned tax plans, the United States enacted the Tax Cuts & Jobs Act ("T.C.J.A.")[28] in late December 2017. Among other things, the T.C.J.A. revised U.S. law as follows:

- The corporate tax rates were reduced to 21%.
- The scope of the C.F.C. rules were expanded.
- The deemed paid foreign tax credit rules in connection with direct investment dividends received by corporations were replaced by an intercompany dividend received deduction ("D.R.D.") applicable to dividends received from 10%-owned foreign subsidiaries.
- Deductions are allowed for the use of foreign-derived intangible income generated by U.S. businesses from operations in the U.S. that service foreign markets.
- Deferral of earnings of a C.F.C. that are derived from the use of intangible property is eliminated.
- Nonrecognition treatment for transfers of business assets to a foreign subsidiary has been eliminated.
- The transfer pricing statute (Code §482) has been amended to increase the income that is deemed to be realized from a transfer of ownership or use of intangible property to a foreign corporation.
- The opportunity to use of hybrid payments of interest and royalties to reduce Subpart F income of C.F.C.'s and taxable income foreign-controlled U.S. companies has been eliminated.
- A Base Erosion and Anti-Abuse Tax ("B.E.A.T.") has been imposed on large U.S. companies and U.S. branches of foreign companies in connection in order to reduce the tax benefit arising from deductible payments to foreign related parties.

Broadened Scope of Subpart F

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

[28] *An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,* Public Law 115-97, U.S. Statutes at Large 131 (2017): 2054-2238.

corporation in which "U.S. Shareholders" own (directly, indirectly, or constructively) shares representing more than 50% of the corporation's voting power or value.

Certain rules of attribution apply to treat shares owned by one person as if owned by another. Shares may be attributed between individuals, corporations, partnerships, trusts, and estates. Consequently, the ownership of a taxpayer's shares in one company could be attributed to another company owned by the same taxpayer for the purposes of determining, *inter alia*, whether the second company is a U.S. Shareholder of a C.F.C. and whether two companies are related because one controls the other or both are under common control. Although ownership of shares is attributed from one person to another for the foregoing purposes, that attribution does not cause the latter person to be taxed under Subpart F on the income of the C.F.C. In other words, income follows legal ownership.

Under prior law, a "U.S. Shareholder" was a U.S. person that owned shares of the foreign corporation having 10% or more of the voting power of all shares issued by the corporation. For this purpose, U.S. persons include U.S. citizens, U.S. residents, U.S. corporations, U.S. domestic trusts or estates, and U.S. partnerships and L.L.C.'s. In applying the attribution rules, shares could not be attributed from a foreign corporation to a U.S. corporation in which shares representing more than 50% of the voting power or value were owned in the U.S. corporation. In addition, before Subpart F could apply to a C.F.C. and its U.S. Shareholders, a foreign corporation was required to be a C.F.C. for at least 30 days during the taxable year.

The T.C.J.A. made several changes to the provisions of Subpart F. First, the definition of a U.S. Shareholder was expanded so that a person is a U.S. Shareholder of a foreign corporation if shares are owned in the foreign corporation and those shares represent at least 10% of the voting power *or the value* of the foreign corporation.

Second, if more than 50% of the shares in a U.S. subsidiary are owned by a foreign parent, the U.S. subsidiary constructively owns shares in all non-U.S. corporations that are actually owned by the foreign parent for the purposes discussed above. As a result, foreign-based groups with members in many countries, including the U.S., may find that all members based outside the U.S. are at risk of becoming C.F.C.'s for certain U.S. tax purposes, with the U.S. affiliate treated as if it were the parent company of the group. This can broaden the scope of information reporting, but not the imposition of tax within the group. However, it can affect unrelated U.S. persons owning 10% or more of the shares of a foreign corporation, causing such U.S. persons to pay tax immediately on its share of any Subpart F income of the newly categorized C.F.C. In essence, this rule attacks certain joint ventures abroad consisting of U.S. businesses and members of a foreign multinational group with subsidiaries in the U.S.

In 2018, the I.R.S. announced that it would not impose a reporting obligation on the U.S. entity in these circumstances, provided that no U.S. entity owns stock in such C.F.C., either directly or indirectly through a foreign subsidiary, and the foreign corporation is a C.F.C. solely because a U.S. entity constructively owns stock in the corporation through a foreign parent. This rule helped foreign based groups having members in the U.S. but not when U.S. persons co-invest directly or indirectly in a foreign joint venture company.

Finally, a foreign corporation is no longer required to be a C.F.C. for 30 days in order for Subpart F to apply to its U.S. Shareholders. This provision affects many

tax plans put in place for high net worth individuals with children who live in the U.S. Those plans typically involved the use of foreign blocker corporations that protected U.S. situs investment assets from the imposition of U.S. estate taxes for a non-U.S. parent. At the same time, the plans allowed the children to have a tax-free step-up in cost basis in the investment assets if the foreign blocker is liquidated promptly after the parent's death.

Cross-Border Intercompany Dividends Received Deduction

Generally, U.S. citizens, residents, and domestic corporations are considered to be U.S. persons subject to tax on worldwide income. To eliminate double taxation of income, the U.S. allows a credit for foreign income taxes paid on foreign-source income. For taxpayers that are corporations, an indirect credit was allowed under prior law for foreign income taxes paid by foreign corporations when the U.S. corporation owned shares in a foreign corporation representing 10% or more of the voting power. Under the indirect foreign tax credit computations, a U.S. Shareholder of a C.F.C. kept track of the pool of the post-1986 earnings of the C.F.C. and the pool of foreign income taxes associated with those earnings. Foreign income taxes associated with post-1986 earnings were deemed paid on a proportional basis as the earnings in that pool were distributed. The indirect foreign tax credit reached down to the sixth level of foreign subsidiary, so long as the U.S. corporation indirectly owned at least 5% of the lower tier subsidiaries.

The T.C.J.A. abandons the indirect foreign tax credit and moves to a D.R.D. system.[29] A 100% deduction is allowed for the foreign-source portion of dividends received from 10%-owned foreign corporations. To be entitled to the D.R.D., a U.S. corporation must hold its 10% interest for more than 365 days in the 731-day period beginning on the date that is 365 days before the ex-dividend date in the declaration.

The D.R.D. is not available for hybrid dividends. These are amounts for which a deduction would be allowed under the D.R.D. rules except that the specified 10%-owned foreign corporation has already received a deduction or other tax benefit in any foreign country. Also, if a C.F.C. with respect to which a domestic corporation is a U.S. Shareholder receives a hybrid dividend from a related C.F.C., the hybrid dividend is treated as Subpart F income of the recipient C.F.C.[30] None of the exceptions to taxation under Subpart F are applicable.

The indirect foreign tax credit remains in effect to eliminate double taxation for U.S. corporations that are taxed under Subpart F in connection with foreign subsidiaries that are C.F.C.'s. However, the indirect foreign tax credit is not applicable to a hybrid dividend that gives rise to an income inclusion for a U.S. corporation that is a U.S. Shareholder.[31]

There is no equivalent to the D.R.D. for repatriations from a foreign branch. Income from foreign branches is taxed immediately and the taxpayer may claim a direct foreign tax credit for foreign income taxes paid. Foreign branch income is placed in a separate foreign tax credit limitation basket.[32]

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29 Code §245A.

30 Code §245A(e)(2).

31 Code §245A(e)(3).

32 Code §904(d)(1)(B).

One-Time Transition Tax Accompanies Transition to D.R.D.

In order to create a level playing field for all earnings accumulated abroad in C.F.C.'s and other non-U.S. corporations in which a U.S. corporation owns sufficient shares to claim an indirect foreign tax credit, all post-1986 earnings of such foreign corporations are deemed to be distributed on the last day of the taxable year beginning prior to January 1, 2018.[33]

If the foreign corporation is a C.F.C., all U.S. Shareholders as defined under prior law report the income. If the foreign corporation is not a C.F.C., only 10% shareholders report the income, provided that at least one such shareholder is a U.S corporation.[34]

The rate of U.S. tax on the amount included in income is reduced by means of a notional deduction.[35] For U.S. corporations, the rate is 15.5% to the extent that the earnings have been invested in cash or cash equivalents, based on the balance sheet of the C.F.C. The balance of the earnings is taxed at a rate of 8%. The rate for individuals is assumed to be marginally higher.

Corporations may claim an indirect foreign tax credit for foreign income taxes paid by the C.F.C. in connection with the post-1986 pool of earnings. However, the pool of foreign income taxes is reduced to reflect the reduction in the tax rate of the U.S. Shareholder.[36]

At the election of the taxpayer, the total tax is computed on the tax return for 2017, but the taxpayer can also elect to pay the tax in eight annual installments, so that 40% of the total tax is paid in equal installments over the first five years and the balance is paid in escalating installments over the last three years.[37]

For individual taxpayers who missed the April 18, 2018, deadline for making the first of the eight annual installment payments, the I.R.S. will waive the late-payment penalty if the installment is paid in full by April 15, 2019.[38] Absent this relief, a taxpayer's remaining installments over the eight-year period would have become due immediately. This relief is only available if the individual's total transition tax liability is less than $1 million.

U.S. Reduced Tax Rate Imposed on Global Intangible Low-Tax Income of C.F.C.'s

The T.C.J.A. enacts a global intangible low-taxed income ("G.I.L.T.I.") regime that is designed to decrease the incentive for a U.S.-based multinational groups to shift corporate profits to controlled subsidiaries based in low-tax jurisdictions.[39]

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33 Code §965.

34 Code §965(e).

35 Code §965(c).

36 Code §965(g).

37 Code §965(h).

38 IR-2018-131 issued on June 4, 2018, announcing three additions to the I.R.S. Frequently Asked Questions on the transition tax.

39 Code §951A.

Computation of Tested Income Under the G.I.L.T.I. Regime

The G.I.L.T.I. regime applies to U.S. Shareholders of C.F.C.'s, as defined above. G.I.L.T.I. applies only to income that is not already taxed in the U.S. either at the level of a C.F.C. or its U.S. Shareholders. Consequently, it is an add-on tax imposed on profits that would have benefited from deferral under prior law.

The first step in computing G.I.L.T.I. is to eliminate the C.F.C.'s items of income that produce current tax.[40] These include the following items of income:

- Business income that is subject to net-basis taxation in the U.S.
- Dividends from a related C.F.C. that are not subject to tax in the U.S. at either the level of the C.F.C. or the level of its U.S. Shareholders because of Subpart F
- All other income of a C.F.C. that results in an immediate U.S. tax under Subpart F for its U.S. Shareholders

The remaining income is referred to as "Tested Income."

Removal of Qualified Business Asset Income

In determining how much Tested Income is treated as G.I.L.T.I., actual economic drivers for generating income are ignored. Instead, all items of C.F.C. income are deemed to arise from either depreciable tangible property used in the business or intangible property used in the business.[41] Consequently, investment in inventory, work in progress, and supplies are lumped into the intangible category because they fail to meet the definition of depreciable tangible property. Similar treatment is provided for the financial assets of a bank that is a C.F.C.

The investment in tangible depreciable property is deemed to generate a 10% yield computed with reference to the adjusted basis of the property.[42] The amount so determined is reduced by interest expense allocated against the tangible depreciable property.[43] The balance of the income is attributable to intangible property, which in turn gives rise to G.I.L.T.I. for U.S. Shareholders of a C.F.C.

Netting of Tested Income

At this point, the positive and negative G.I.L.T.I. results for each C.F.C. owned by the same U.S. Shareholder are aggregated. The U.S. Shareholder reports the net amount of G.I.L.T.I. on its U.S. Federal tax return. The aggregate amount is then allocated to each C.F.C. with positive Tested Income.

Foreign Tax Credit Computations

When a U.S. Shareholder is a corporation, several additional computations are required:

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40 Code §951A(c)(2)(A)(i).

41 Code §951A(b)(1).

42 Code §951(b)(2)(A).

43 Code §951(b)(2)(B).

- First, a deemed foreign tax credit is allowed for foreign income taxes attributable to G.I.L.T.I.[44] The starting point in determining those taxes is to identify the C.F.C.'s total foreign income taxes paid.

- Second, the foreign income taxes attributable to income not included in Tested Income are removed. Again, these are foreign income taxes attributable to Subpart F Income of the C.F.C. or income arising from a business conducted in the U.S. What remains are "Tested Foreign Tax Credits."

- Third, the portion of the total Tested Foreign Tax Credits that are attributable to the 10% yield on depreciable tangible property must be identified and removed from the pool. What remains are Tested Foreign Tax Credits attributable to G.I.L.T.I.

Because the foreign tax credit in this scenario relates to taxes actually paid by the C.F.C. but attributed to the corporate U.S. Shareholder – sometimes called a deemed-paid or indirect credit – the taxes for which the credit is claimed must be added to the amount otherwise reported as taxable. This is referred to as a gross-up.[45] Its purpose is to equate the deemed-paid credit to a direct foreign tax credit of a branch of the U.S. corporation. There, the payment of the creditable tax does not reduce taxable income – just as the Federal income tax does not reduce U.S. taxable income.

The foreign income taxes attributable to G.I.L.T.I. are placed in a separate foreign tax credit limitation basket. The separate basket ring-fences the income and creditable taxes so that the U.S. tax on G.I.L.T.I. cannot be offset by excessive taxes on income in other baskets. The amount of foreign taxes creditable to G.I.L.T.I. is then multiplied by an inclusion percentage (discussed below) and reduced by 20% so that only 80% of available foreign tax credits attributable to G.I.L.T.I. are ultimately creditable.[46] This reduction has no effect on the gross-up under Code §78.

The inclusion percentage reflects the fact that the G.I.L.T.I. inclusion is determined by netting profitable G.I.L.T.I. operations of C.F.C.'s owned by the corporate U.S. Shareholder with unprofitable operations. Again, profitable operations and unprofitable operations are determined on an after-tax basis at the level of the C.F.C. The pool of available foreign tax credits must then be reduced to reflect the benefit of the netting computation. Consequently, the inclusion percentage is determined by dividing (i) the net G.I.L.T.I. inclusion reported by the corporate U.S. Shareholder by (ii) the gross Tested Income of all C.F.C.'s having positive Tested Income. Only foreign income taxes paid by subsidiaries that report positive G.I.L.T.I. may be claimed as an indirect foreign tax credit.

The foreign tax credit limitation is computed based on a 21% corporate income tax. To the extent foreign income tax on Tested Income tax cannot be credited by the corporate U.S. Shareholder in the year of the G.I.L.T.I. inclusion, the tax is lost forever. No carryback or carryforward is provided for unused G.I.L.T.I.-related foreign tax credits. Consequently, the lost taxes reflect each of the following computations:

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44 Code §960(d).

45 Code §78.

46 Code §960(d)(1).

- Application of 80% cap on the pool of available foreign taxes
- Foreign income taxes imposed on a C.F.C. that reports negative Tested Income on an after-tax basis
- Foreign income taxes in excess of the foreign tax credit limitation based on the 21% corporate tax rate in the U.S.

50% Deduction for Corporate U.S. Shareholders

Once the gross amount of G.I.L.T.I. is determined, a U.S. Shareholder that is a corporation is entitled to a 50% deduction based on the amount of G.I.L.T.I. included in income.[47] Because the rate of corporate tax in the U.S. is 21%, a corporate U.S. Shareholder's effective tax rate on G.I.L.T.I. will be 10.5%. If foreign taxes are available to be claimed as a credit, the effective rate of tax must take into account the 20% of deemed paid taxes that are not available for any credit. This makes the effective rate of U.S. tax 13.125%.

The deduction is not available to individuals. However, individuals may elect to create a silo of income and taxes with regard to G.I.L.T.I. Income in the silo can be taxed as if earned by a corporation.[48] The income in the silo is entitled to the 50% deduction,[49] as the legislative history of the T.C.J.A. describes the deduction as a "reduced rates" mechanism.[50] This characterization is important because an individual making the election to be taxed at corporate rates generally is not entitled to deductions, except as allowed in the provision allowing for the election.

"At the same time the T.C.J.A. accelerated tax under the G.I.L.T.I. regime for certain profits derived abroad from active business operations, it also provided a deduction for U.S. corporations operating in the U.S. to expand sales of products and services abroad."

Foreign-Derived Intangible Income Deduction for Domestic Operating Income of U.S. Companies Related to the Exploitation of Foreign Markets

At the same time the T.C.J.A. accelerated tax under the G.I.L.T.I. regime for certain profits derived abroad from active business operations, it also provided a deduction for U.S. corporations operating in the U.S. to expand sales of products and services abroad.[51] The deduction relates to foreign-derived intangible income ("F.D.I.I.") and shares many of the technical concepts of the G.I.L.T.I. regime, albeit in the context of exports.

F.D.I.I. is the portion of a U.S. corporation's intangible income derived from serving foreign markets, determined by a formula. The F.D.I.I. of any U.S. corporation is the amount that bears the same ratio to the "deemed intangible income" of the corporation as its "foreign-derived deduction eligible income" bears to its "deduction eligible income."

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47 Code §250.

48 Code §962.

49 Prop Treas. Reg §1.962-1(b)(3).

50 See U.S. Congress, House of Representatives, Committee of Conference, *Conference Report on H.R. 1, Tax Cuts and Jobs Act,* 115th Cong., 1st sess., 2017, H. Rep. 115-466 at note 1515. See also note 1516, referring to the deduction as a method to reduce corporate tax rates.

51 Code §250.

Several new terms must be understood to compute the F.D.I.I. deduction:

- "Deemed intangible income" means all deduction eligible income in excess of "deemed tangible income" return.
- "Deemed tangible income" means a 10% return on the average basis in depreciable tangible property used in a trade or business and of a type for which a depreciation deduction is allowed.
- "Deduction eligible income" means, with respect to any U.S. corporation, the amount by which (i) gross income (excluding certain income items taxed in connection with operations conducted outside the U.S. directly or through a C.F.C.) exceeds (ii) allocable deductions (including taxes).
- "Foreign-derived deduction eligible income," means deduction eligible income derived in connection with property that is sold by the taxpayer to any person who is not a U.S. person. The sale must be made for use, consumption, or disposition outside the U.S. by the purchaser. If services, they must be provided by the taxpayer to any person not located in the U.S. or with respect to property not located in the U.S. The I.R.S. is given broad discretion in determining whether the taxpayer has met its burden of proof in establishing that property has been sold for use outside the U.S. or services have been performed for persons or with regard to property located outside the U.S.
- The terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. "Foreign use" means any use, consumption, or disposition outside the U.S.

A U.S. corporation may claim a 37.5% deduction for the foreign-derived deduction eligible income when computing taxable income. The intent is to impose a 13.125% rate of tax on these profits.[52] This deduction is not available to individuals who operate a business through a limited liability company.

Base Erosion and Anti-Abuse Tax

The T.C.J.A. introduced a minimum tax provision for large corporations that significantly reduce their U.S. tax liability through the use of cross-border payments to related persons.[53] Known as the Base Erosion and Anti-Abuse Tax (the "B.E.A.T. Regime"), the provision is viewed to be an attack against inbound base erosion through intercompany service fees, interest, rents, and royalties ("Base Erosion Payments")[54] paid to 25% foreign related persons.[55] The B.E.A.T. Regime generally applies to corporate taxpayers that have average annual gross receipts of $500 million or more during the testing period (the "gross receipts test") and whose deductible payments to related parties equal or exceed 3% of their total allowed deductions (2% for certain banks and securities dealers).[56]

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52 Code §250(a)(1)(A).

53 Code §59A.

54 Code §59A(d).

55 Code §59A(g).

56 Code §59A(e)(1).

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

If applicable, the B.E.A.T. Regime compares a tax of 10% (5% in 2018) imposed on the modified taxable income of a U.S. corporation with the 21% tax imposed on regular taxable income. If the tax on modified taxable income exceeds the regular tax, the excess is added to the regular tax for the year.

Modified taxable income under the B.E.A.T. Regime is broader than the concept of taxable income for regular tax purposes.[57] It is determined by adding the following items of deductible expense to the corporation's taxable income:

- Deductions allocated to Base Erosion Payments in connection with payments made to 25% foreign related parties
- Depreciation and amortization deductions related to property purchased from 25% foreign related parties
- A specified portion of net operating losses from earlier years

For this purpose, a foreign entity is considered to be a 25% related foreign entity with regard to a corporation if it meets any of the following criteria:

- It is treated as owning shares in the U.S. corporation that represent at least 25% of the voting power or the value of all shares issued and outstanding.
- It is related to the corporation or to a 25% foreign owner of the corporation under constructive ownership rules similar to those discussed above that generally require more than 50% common ownership between two persons.
- It is treated as related to the taxpayer under the arm's length transfer pricing principles of U.S tax law. This means that one party controls the other or they are both under common control, no matter how exercised.

Certain payments that reduce U.S. tax are expressly removed from coverage under the B.E.A.T. Regime. These include the purchase price for inventory[58] and certain services that are generally of a kind that can be charged to a related party without a mark-up over costs without running afoul of the arm's length transfer pricing rules of U.S. tax law.[59] The I.R.S. is authorized to issue regulations that are necessary to prevent the avoidance of the B.E.A.T. Regime. Examples of abusive transactions include the use of unrelated persons, conduit transactions, or other intermediaries, or transactions or arrangements in ways that are designed, in whole or in part, to improperly recharacterize payments for the purpose of avoiding the B.E.A.T. Regime.

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[57] Code §59A(c).

[58] Preamble to REG-104259-18, Section III (Base Erosion Payments).

[59] Code §59A(d)(5).

Limitations Placed on Business Interest Expense Deductions

Prior to the T.C.J.A., U.S. subsidiaries of foreign corporations were subject to an earnings stripping rule that applied when interest was paid to related parties outside the U.S. in circumstances where withholding tax was reduced or eliminated.[60] A cap was placed on the deduction for interest expense paid to a related party where the full 30% withholding tax was not collected, typically under the terms of an income tax treaty. The cap applied when the total net interest expense exceeded 50% of what is essentially E.B.I.T.D.A. and the debt-to-equity ratio exceeded 1.5 to 1.

The T.C.J.A. modifies the scope of these rules so that a ceiling is placed on the deduction for all business interest expenses. For taxable years beginning after 2017, the deduction for business interest is limited to the sum of business interest income and 30% of what is essentially E.B.I.T.D.A. for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely, subject to certain restrictions applicable to partnerships. Special rules exempt floor plan financing interest, which is typically used by automobile dealers,[61] as well as certain electing real property, farming, and utilities businesses, from the application of the 30% ceiling.[62]

Beginning in 2022, the ceiling is tightened by replacing the E.B.I.T.D.A. base with an E.B.I.T.-related base. At that point, depreciation, amortization, and depletion will no longer be added back to income when determining the base on which the 30% cap is computed.

Certain businesses are not covered by the ceiling. These include, *inter alia*, taxpayers with less than $25 million in average annual gross receipts for the period of three taxable years ending with the prior taxable year and electing real property trades or businesses.[63]

Other Revisions Affecting Cross-Border Groups

The T.C.J.A. made several other revisions to U.S. tax law affecting cross-border investors. The following list contains some of the more important changes:

- When valuing intangible property that is sold, transferred, or licensed to a related party, a taxpayer must consider realistic alternatives to the transaction as the methodology utilized by the taxpayer must apply the aggregate basis of valuation rather than an asset-by-asset method.[64]
- An exception to immediate gain recognition provided under prior law was eliminated,[65] resulting in the immediate recognition of gain in connection with a transfer of tangible assets used in an active trade or business to a related party outside the U.S.

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60 Code §163(j).

61 Code §163(j)(1)(C).

62 Code §163(j)(7)(A).

63 Code §§163(j)(3) and 448(c).

64 Code §482.

65 Code §367(a)(3) prior to enactment of the T.C.J.A.

Biden Tax Proposals

In late Spring 2021, the Biden Administration announced its tax policies to pay for a spending program on domestic infrastructure and other items. As of June 30, 2021, there is much speculation on which of the specific provisions will make it into a final bill that can be approved by both the Senate and the House of Representatives and signed by the President.

"New I.R.S. regulations were adopted at the end of 2021 that are designed to limit the ability of U.S. taxpayers to offset U.S. tax by a credit for digital services taxes and other taxes that are imposed under foreign law. . ."

The highlights of the Biden Administration tax proposals addressing cross-border taxation are as follows:

- The corporate tax rate would be increased to 28%.
- A 15% minimum tax would be imposed on book income of corporations reporting more than $2.0 billion of income for book purposes, as adjusted for certain items such as credits and book net operating losses.
- The anti-inversion rules would be strengthened by treating any acquisition of 50% or more ownership of a U.S. target or after the acquisition by a foreign corporation, the target continues to be managed or controlled by U.S. persons.
- The F.D.D.I. rules will be repealed and replaced by some form of research and development incentive targeted to U.S. activity.
- Both negative and positive incentives will be applied to grow jobs in the U.S. A 10% general business credit would be given for expenses incurred in connection with on-shoring of jobs. Expenses incurred in off-shoring of a U.S. trade or business would be nondeductible.

U.S. Foreign Tax Credit Regulations

New I.R.S. regulations were adopted at the end of 2021 that are designed to limit the ability of U.S. taxpayers to offset U.S. tax by a credit for digital services taxes and other taxes that are imposed under foreign law, based on the assertion that the location of the customers creates a digital presence in the country.

Under long-standing principles followed by the I.R.S., a foreign income tax for which a foreign tax credit is claimed under U.S. tax law must be structured so that it is imposed on the net gain of the taxpayer. Three tests must be met in order for a tax to meet the net gain requirement:

- The realization test
- The gross receipts test
- The net income test

Under the realization test, the tax must be imposed at the time when income is realized.[66] Under the gross receipts test, the tax must be imposed on gross receipts or the equivalent.[67] Under the net income test, the tax must be imposed on net income

[66] Treas. Reg. §1.901-2(b)(2)(i).

[67] Treas. Reg. §1.901-2(b)(3).

after allowing for the recovery of expenses through immediate deductions against income or amortization of the total expenditure over time.[68]

In addition to the historic tests, the new regulations require close conformity to U.S. tax law and an attribution requirement that examines the jurisdictional basis for imposing tax. A nexus must exist between the transaction and the authority of the foreign government to impose tax. If an appropriate nexus does not exist, the tax is not a creditable income tax. As a result, some foreign taxes that were creditable under prior regulations may no longer be claimed as a credit. One of three nexus tests must be met in order for a foreign tax to have jurisdictional nexus to tax income.[69] The first is an activities test. It broadly mirrors activities that would cause the income of a foreign enterprise to be taxed in the U.S. as effectively connected income. The second test is a source of income test. Under that test, the income that is taxed by the foreign country must be based on source rules that are similar to those in the U.S. that are applied to foreign enterprises providing services in the U.S. or licensing intangible property for use in the U.S.[70] The third test is based on the location of property. For a tax on the disposition of real property to be creditable, the income or gain must be taxed by the foreign country based on concepts similar to those of F.I.R.P.T.A. For a tax on the disposition of personal property to be creditable, the income or gain must be taxed by the foreign country because it is business property of an office or fixed place of business of the enterprise in the country.[71]

The regulations take particular aim at taxes imposed under destination-based criteria, such as the location of a company's customers. This typically addresses digital services taxes which are imposed based on the location of the customer base.

PATH FORWARD

Until this point, this paper has looked in general at the challenges faced in cross-border tax planning in Europe and under the B.E.P.S. Project, and in a focused way, in the U.S. under the T.C.J.A. The balance of this paper will examine the challenges now faced by tax planners within Europe.

We begin with a detailed look at how the B.E.P.S. Project has affected tax plans and how the European Commission is applying the concept of unlawful State Aid and the Anti-Tax Avoidance Directives to challenge sophisticated cross-border plans to achieve tax savings that were valid until just a few years ago. The paper then proceeds to examine the tax treatment of holding companies in each of fifteen European jurisdictions.

The goal is to determine whether a particular European country provides tax treatment – alone or in conjunction with a second jurisdiction – that makes the formation of a holding company attractive to a U.S.-based group of companies. It must be staffed with competent persons having authority to make decisions and must avoid being a conduit to the U.S. parent. For many U.S. planners advising corporate

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[68] Treas. Reg. §1.901-2(b)(4)(i).

[69] Treas. Reg. §1.901-2(b)(5)(i)(A).

[70] Treas. Reg. §1.901-2(b)(5)(i)(B).

[71] Treas. Reg. §1.901-2(b)(5)(i)(C).

groups, this represents a major change of thinking, as the group's substance is frequently attributed to all group members ¬– even those having no employees. In today's world, tax benefits must be seen as non-abusive and business plans must be generated by operational personnel rather than tax advisers. A structure that is recommended based solely on the arithmetic rate of tax – net income multiplied by a low corporation tax rate – will likely face unpleasant surprises on both sides of the Atlantic.