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The Substance of Boxes

By Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

The realm of international and cross-border taxation has been steadily moving in the direction of insisting that a corporation in an international structure — a box on the structure chart — have ''substance'' in order to be respected. By ''substance,'' what seems ordinarily to be meant is that the corporation have employees or activities, or at least that there was a non-tax reason to set up the corporation in the country where it was set up. Even though the United States pretty much invented the idea that tax planning would be respected only if it accords with ''economic substance,'' the idea that a box on a page needs substance to be respected as such is completely foreign (forgive the pun) to our tax rules. While the United States applies economic substance principles to *transactions*, it does not apply such principles to *entities*.

In this article I will survey current developments in this regard, and offer some thoughts to explain why U.S. tax law respects boxes on a page — and why much of the rest of the world is heading in the opposite direction.

U.S. tax law is generally highly respectful of the separate entity status of a corporation.[1] While the courts will occasionally ''pierce the corporate veil,'' this is rare and occurs only where corporate formalities are utterly ignored, and usually only where there are indications of fraud.[2] Separately, the courts on rare occasions will ignore the separate status of a corporation for income tax purposes where it is clearly acting as an agent or nominee, but only if the relationship between the principal and agent displays the usual incidents of an agency relationship, and where the principal's control in its capacity as agent is independent of its control as a shareholder.[3]

U.S. tax law uses a bright-line residency rule for corporations that looks solely to the place of incorporation.[4] This means that U.S. tax law is indifferent to where a corporation is managed or controlled. This rule works both ways: a domestic corporation may be wholly managed outside the United States and will still bear full U.S. tax on its worldwide income, whereas a foreign corporation may be managed wholly within the United States and still be taxable only upon its U.S.-source income and effectively connected income.

It is generally not possible for a U.S. corporation to expatriate itself, or to transfer its assets offshore, without full U.S. taxation. In fact, most transfers of affiliate stock offshore, even within a controlled group, are subject to current tax.

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[1] The leading case for this proposition is the U.S. Supreme Court's decision in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), which has stood the test of time. This discussion focuses on the treatment of ordinary ''C'' corporations. The special rules applicable to S corporations, REITs and RICs are not covered here.

[2] *See Seymour Pollack*, T.C. Memo 1982-638; *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 326–327 (Wyo. 2002) (''The concept of piercing the corporate veil is a judicially created remedy for situations where corporations have not been operated as separate entities as contemplated by statute and, therefore, are not entitled to be treated as such. The determination of whether the doctrine applies centers on whether there is an element of injustice, fundamental unfairness, or inequity. The concept developed through common law and is absent from the statutes governing corporate organization'').

[3] *See* Rev. Rul. 75-31, 1975-1 C.B. 10; *Commissioner v. Bollinger*, 485 U.S. 340 (1988).

[4] The inversion rules of §7874 can cause a foreign-incorporated entity to be treated as a domestic corporation (as can §1503(d) and the stapled stock rules of §269B), but the rules never operate to treat a U.S.-incorporated entity as foreign.

All section references (''§'') are to the U.S. Internal Revenue Code, as amended.

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The United States is the only major industrial country that subjects a domestic corporation to full tax on its worldwide income regardless of source. This includes foreign dividend income as well as gains on the sale of stock of a foreign corporation. Capital gains are fully taxable, even on the disposition of a wholly owned subsidiary.[5] Distributions of appreciated property to a shareholder, including in liquidation, are fully taxable to the distributing corporation, with an exception for the liquidation of a majority-owned subsidiary, where stock basis disappears and asset basis carries up to the parent. Even a spin-off that leaves all appreciated assets in corporate solution can be taxable unless strict requirements are satisfied. Taken as a whole, the U.S. tax system applicable to domestic corporations is like a roach motel — once property is put into the corporate box, you cannot get it out, at least not without paying full corporate-level tax.

Nor can domestic corporations be used to treaty-shop. The existence of the impermeable U.S. corporate tax virtually ensures that no third-country resident would seek to treaty-shop through the United States. And in any case, all significant U.S. tax treaties contain a limitation on benefits (''LOB'') provision. The purpose of the LOB clause contained in U.S. tax treaties is not primarily to prevent foreign nationals from treaty-shopping *through* the United States, but is generally to prevent foreign nationals from treaty-shopping *into* the United States.

Given the impermeability of the corporate form, no person of any nationality would form a U.S. corporation as part of any tax planning scheme. This likely explains why U.S. tax rules do not bother to ask about ''substance.'' If there is a U.S. corporation on the structure chart, it will be respected because it will be subject to tax on its worldwide income and cannot possibly be used in a manner that would result in the inappropriate reduction of the owner's taxes. In effect, worldwide taxation without exit is a proxy for ''substance.''

While these U.S. tax rules virtually ensure the tax integrity of the U.S. corporate ''box,'' the same is generally not true of other countries' rules. Outside of the United States, it is common to find territorial regimes, cross-border dividends-received exemptions, exemptions from tax on capital gains (at least on sale of foreign affiliate stock), the ability to move offshore tax-free via a change of place of management, tax-deductible equities, special regimes such as patent boxes, and more. The ubiquity of these types of tax rules explains why many countries are suspicious of boxes on a page: They suspect that somehow, somewhere, someone is getting away with something (which may in fact be the case).

As is well known, there is a fight going on at the level of the Organization for Economic Cooperation and Development over how tax treaties should be limited so as not to permit abusive practices such as treaty-shopping and ''double non-taxation'' of income. No one disagrees that treaties should not be so used; the fight is over how treaties should be drafted in order to arrive at the intended result. The United States, which has a long history of using various tests to prevent treaty-shopping,[6] stands nearly alone in insisting upon the use of a limitations on benefits test (''LOB'') and opposing any principal purpose test (''PPT''). Most of the rest of the world wants a PPT, in part because they find the LOB too inflexible and in part because they worry that an LOB cannot address certain treaty abuses.

Some countries appear to believe that insisting upon a corporation having ''substance'' will ameliorate the problem of treaty-shopping through intermediate corporations. But ''substance'' is no substitute for clear anti-conduit rules and objective rules such as those contained in an LOB. Moreover, using a substance test in this way disqualifies many structures that are anodyne. There is nothing *per se* abusive about the use of passive holding companies that lack any substance whatsoever. Note that the LOB itself has a test — the active trade or business test — that in many ways functions as a substance test, without having to inquire into motive, intent, or purpose. The active trade or business test generally permits even an empty holding company to claim treaty benefits, so long as some affiliate is conducting an active business in the same country, and this is appropriate treaty policy.

The treaty approach gap is likely unbridgeable, in my view in large part because the two sides are talking past one another. Among other problems with a PPT, it would enable another country to deny treaty benefits to a U.S. corporation even though such corporation is taxable on its worldwide income. This seems like a non-starter.

As I was putting the finishing touches on this small note, a delegation of representatives going by the name of the ''European Parliament's Panama Papers Investigative Committee'' was visiting the State of Delaware to, among other things, ''probe issues such

[5] The §338(h)(10) election recognizes that such gains should be taxed only once inside a consolidated group, and thus permits a group member that has sold stock of another group member to elect to treat the target as having sold assets in lieu of its shareholder selling stock.

[6] For a good recent review of the history of the U.S.'s campaign to prevent treaty-shopping, see Macdonald, *'Time Present and Time Past': U.S. Anti-Treaty Shopping History, Policy, and Rules*, 70 Tax Lawyer 5 (Fall 2016).

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as . . . company beneficial ownership rules.''[7] And as I've noted in past pieces for this journal, some policymakers in the European Union seem to have developed the opinion that the United States, or maybe just Delaware, is some kind of tax haven, notwithstanding having the highest corporate tax rates in the world.[8]

This would be comical if it hadn't gotten so out of hand. Apart from confusing state incorporation laws with federal tax laws, these kinds of investigations are premised in part upon the erroneous assumption that somehow a non-U.S. taxpayer could ''hide'' assets behind a U.S. state-law corporation. For the reasons set out above, about the last place in the world a foreign person would park money would be in a U.S. (Delaware or other) corporation, instantly converting non-U.S.-source income exempt from tax in the United States into income fully subject to U.S. income taxes. It matters not a bit whether any U.S. government authority knows who the owners of a domestic corporation are, since the domestic corporation will be fully subject to U.S. tax and will be required to withhold tax on distributions to its shareholders absent identifying documentation. The only significance to knowing who owns a domestic corporation is the taxpayer-favorable one of reducing double or triple confiscatory taxes upon U.S.-source dividends where a treaty applies![9]

As long as policymakers around the world continue to be ignorant about the manner in which the United States taxes domestic corporations, there will continue to be misunderstandings in negotiating tax treaties and in approaching the problems of global taxation and transparency.

[7] *See* Kirwin, *EU Lawmakers to Visit IRS, Delaware as Tax Haven Concerns Mount*, 53 Daily Tax Rep. I-1 (Mar. 21, 2017); Kirwin, *EU Panama Papers Probe Head: U.S. Tax Loopholes Must Be Closed*, 57 Daily Tax Rep. I-1 (Mar. 27, 2017).

[8] *See* Blanchard, *Taxes and State Aid: Some Light To Go With the Heat*, 45 Tax Mgmt. Int'l J. 671 (Nov. 11, 2016); Blanchard, *Some Comic Relief: Musings on Delaware as a Tax Haven*, 39 Tax Mgmt. Int'l J. 609 (Oct. 8, 2010).

[9] As I've noted before, there might be legitimate concerns over foreign persons' use of U.S. state law LLCs; see ''Comic Relief,'' n. 8 above. This was the reason that the IRS recently proposed regulations under §6038A treating a disregarded entity wholly owned by a foreign person as a domestic corporation for reporting rule purposes. REG-127199-15, 81 Fed. Reg. 28,784 (May 10, 2016).

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