US Inbound Corner | Navigating complexity

US Tax Treaties: Tax Court says treaty does *not* override the Code requirement that taxpayers file returns as a condition for claiming US deductions

On January 21, the US Tax Court answered a treaty question of first impression for US courts: If rights to deductions, and nondiscriminatory treatment, are afforded to a taxpayer by treaty, can the Internal Revenue Code take those deductions away on the grounds that a taxpayer failed to file a tax return until after the IRS prepared one for the taxpayer? "Yes," said the Tax Court in *Adams Challenge (UK) Ltd v. Commissioner*, 156 T.C. No. 2, construing the US-UK income tax treaty (the "Treaty"). This article is intended to hit some highlights of that decision.

Sections 874 and 882(c)(2)

By what's sometimes called "legislative grace," the Code allows taxpayers to claim deductions when computing "taxable income." However, *foreign* payers of US income taxes (the taxes imposed by section 1 (on individuals and section 11 (on corporations)) are expressly warned by the Code to file US tax returns or forego all deductions, and nearly all credits. See sections 874 (for nonresident alien individuals) and 882(c)(2) (for foreign corporations). Courts say that to claim deductions, foreign taxpayers must generally file their returns *before the IRS does so*[i]. (If a person fails to make a required return by

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the due date, US law says that the IRS "shall make," from its own knowledge, and sign the person's return.[ii])

There's no comparable condition on the claiming of deductions by US citizens, resident aliens, or domestic corporations. Thus, the Code expressly takes deductions away from delinquent nonfilers if and only if they are foreign.

Articles 7 (Business Profits) and 25 (Nondiscrimination) of the Treaty

Under some of the treaties, deductions "shall be allowed" in determining the business profits of a resident of the other country's US permanent establishment ("PE"), that the United States can tax. Treaties may also provide that US tax on the resident's US PE "shall *not* be less favourably levied" than the US tax on US residents "carrying on the same activities." The US-UK income tax treaty has both of these provisions.

Facts of the case

Adams Challenge (UK) Ltd. was a UK resident company, eligible for Treaty benefits, that owned and operated a ship that helped "decommission" offshore oil and gas facilities in the Gulf of Mexico (on the outer continental shelf) in 2009, 2010, and 2011. Last year, the Tax Court held that in doing so, the company was carrying on a trade or business in the United States through a US PE.[iii]

After receiving an IRS jeopardy assessment dated October 2013, the company, in 2013, filed its US corporate income tax return (Form 1120-F) for 2011. The company waited *until 2017* to file US returns for 2009 and 2010. That was almost three years *after* the IRS had already done so (in April 2014), and two years after the company had filed the Tax Court petition that led to the 2020 decision referred to above, as well as the January 21, 2021 decision, which is the focus of this article.

2021 Tax Court decision

In its January 21, 2021 decision, the Tax Court held that the company could *not* avail itself of the Treaty to avoid the statutory prohibition on claiming deductions for 2009 and 2010.

The decision holds that section 882(c)(2) is in harmony with the "shall be allowed" language in the Treaty, because a UK corporation can deduct business expenses by taking the "administrative steps" specified by section 882(c)(2).

The decision also holds that section 882(c)(2) is in harmony with the "shall not be less favourably levied" language in the Treaty. The Court found "considerable evidence" that *neither* Treaty country viewed this language as overriding section 882(c)(2). To the contrary, the US Treasury Department had been on public record since 1996 that the return-filing condition would *not* violate the identical language in the "model income tax convention" published by Treasury in 1996. In the absence of a record of the United Kingdom affirmatively *disagreeing* with the US view, the Court found it "reasonable to assume" that if the United Kingdom intended the Treaty to override section 882(c)(2), which is the current version of a US statutory provision that has been on the books since the 1930s, the United Kingdom "would have made this point explicitly." Moreover, in light of the many treaties with similar provisions, the Court observed:

> *If all these treaties override section 882(c)(2), a statute that has existed essentially unchanged for 92 years would become largely meaningless. We have no doubt that Congress and Treasury would regard this as an absurd result, and there is no evidence that British tax authorities would feel differently.*

Conclusion

Unless and until this decision is reversed on appeal, it's a reminder that even treaty-country residents must be on the alert for situations where their judgments about whether they have a US taxable presence may differ from the IRS'. It's a reminder that in those situations, taxpayers should consider filing "protective" US income tax returns *before* the protection afforded by such a return becomes unavailable.

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State and local credits and incentives consideration for inbound US companies

The United States ("US") has consistently been among the top countries for foreign direct investment ("FDI") since the World Bank began tracking the metric in 1970.[iv] The inbound investment activity in the United States is robust and dynamic. Chart 1 (based on data from the United States Department of Commerce, Bureau of Economic Analysis) demonstrates the relative measurement of the nominal amount of foreign direct investment into the United States, and Chart 2 (also based on data from the United States Department of Commerce, Bureau of Economic Analysis) demonstrates the countries initiating investment into the United States in 2019.

Chart 1[v]

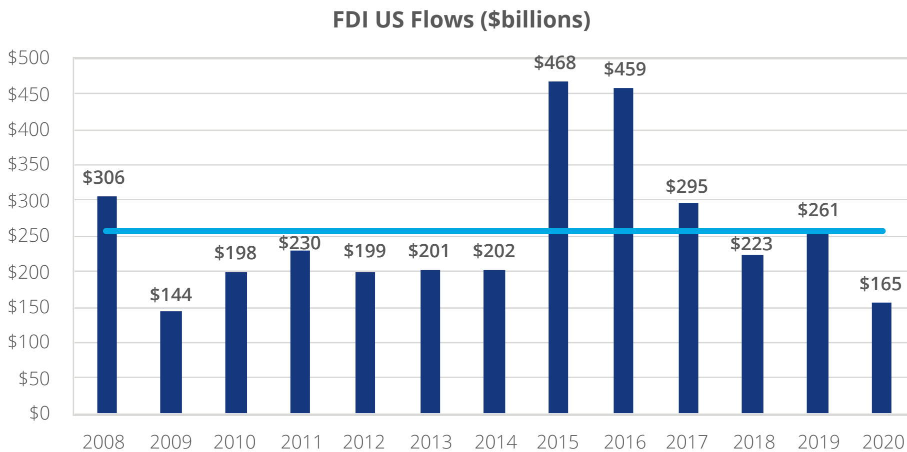
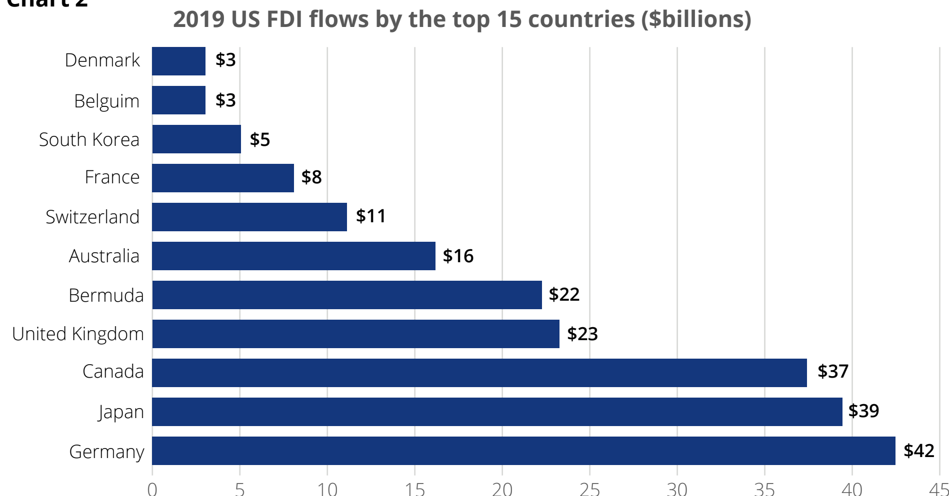


Chart 2[vi]



Navigating the complexity of investing in the US for inbound companies

Inbound multinational companies are likely seeking credits and incentives ("C&I" or collectively, "incentives") as they enter the United States or expand operations here. Navigating the complexity of investing in the United States and seeking support through C&I can be challenging but also rewarding.

US C&I landscape for inbound investors

Numerous credits and incentives programs are available in the United States at federal, state, and local levels. To an inbound US investor, the array of incentive programs, as well as both the process to secure initial approvals for participation in a program and the compliance reporting required to monetize the related benefits, can be daunting. Accordingly, when considering location options, it is important for a foreign investor to understand the US incentives landscape.

This article is primarily focused on C&I programs available through state and local governments. Often, programs offered by state and local governments in the United States have competitive aspects that require a demonstration that, but for the incentive, the investment or project may *not* move forward in the jurisdiction. The incentive may *not* be available if *not* negotiated and agreed to prior to the final site selection decision, including public or private commitments. This is a different structure than is often found in many other parts of the world, where the incentive process is generally more centralized.

Generally, the fifty states and thousands of local jurisdictions (within said states) may offer incentives that could change from year to year. Incentive benefits may be delivered in the form of cash grants, income tax credits, sales tax incentives, property tax incentives, infrastructure funding, and utility incentives, as well as in-kind incentives such as free land or workforce development. While some jurisdictions may be limited to established incentive programs, in certain instances, incentives may be customized for a specific project.

In order for a foreign investor to determine which US incentives have potential benefit, the first step is to prioritize what is of value to the investor's contemplated US operation. Is the company a manufacturing, distribution, or service-oriented operation? If it is a manufacturing operation, is it an industrial process (i.e., extensive use of raw materials and high utility usage) or a light manufacturing process (basic assembly)? Clearly defining operational priorities and functional attributes may help identify which incentives are likely to have an impact on the location decision.

Many companies are interested in cash-equivalent incentives that lower up-front capital outlays or ongoing operating costs. Examples include cash grants, subsidized real estate, and property tax abatements and exemptions.

Another type of incentive that inbound investors may want to be aware of is the opportunity and value of local incentives programs, which may be nonmonetary, such as fast-track permitting, waiver of planning or permit fees, and employee recruiting support, which can be part of a broad-based incentives package. These local incentives can increase speed to market and can be available in conjunction with traditional direct cash and cash-equivalent incentives.

Statutory credits are available by statute for a designated activity, typically without preapproval. Generally, they are claimed in the tax year for which qualifying activity occurred but often they can be retroactively claimed by filing an amended income tax return or other filing. Statutory credits should also be considered, such as income tax credits to reduce tax liability. Statutory tax credits can include job credits for new employment, investment tax credits for qualified capital investments, employee training credits, and others. In addition, state statutory sales tax credits, exemptions, and other benefits may be available.

Discretionary incentives typically require application and preapproval in order to be eligible for such programs. The form of discretionary incentives may include tax credits, tax exemptions/abatements, cash grants, and other tax/financial incentives.

US C&I response to COVID-19

The United States has implemented several economic strategies to help businesses cope with decreased commercial activity due to COVID-19. The US federal government created two specific programs designed to help businesses retain employees: the Employee Retention Credit ("ERC") and the Paycheck Protection Program (PPP).

On March 11, 2021, the president signed the American Rescue Plan Act of 2021, H.R. 1319, (the "Act") into law, which extends the ERC through the end of 2021. Under this extension, the credit limit is up to $7,000 per employee per quarter (i.e., maximum of $28,000 credit per employee for 2021).[vii] The Act establishes new eligibility requirements for certain start-up businesses and businesses that have been severely financially impacted, starting in calendar 2021 Q3 and Q4. The eligibility requirements remain unchanged for companies that do *not* satisfy either of the two new eligibility categories established by the Act.[viii]

The PPP provides businesses with 500 or fewer employees a loan to pay up to eight weeks of payroll costs, including benefits (businesses with over 500 employees can qualify in certain industries).[ix] Funds can also be used to pay interest on mortgages, rent, and utilities. This loan can be forgiven if employee and compensation levels are maintained and the loan proceeds are spent on eligible expenses of which at least 60% must be payroll costs.[x] Loan payments are deferred for six months, and no collateral or personal guarantees are required. For the loan to be forgiven, the employer must maintain or quickly rehire employees while maintaining salary levels. The amount forgiven decreases for businesses that reduce employee headcount or compensation.

States have had mixed approaches to adapting economic development incentives in response to the COVID-19 pandemic. Many are still evaluating various COVID-19-related responses, including how to treat remote workers, as an increasing share of businesses consider permanent remote employment options.

Some states may be open to relaxing incentive program requirements, such as reducing or postponing employment and/or capital expenditure milestones. Other states are establishing new C&I programs in response to COVID-19.

Georgia, for example, has created targeted incentives programs for businesses that produce COVID-19-related supplies, such as personal protective equipment ("PPE") to stimulate economic growth and combat COVID-19.[xi] Georgia's PPE Manufacturer Job Tax Credit is a $1,250 per job bonus to the Georgia Jobs Tax Credit. It applies to businesses manufacturing PPE in Georgia and is effective for tax years beginning on or after January 1, 2020 and is scheduled to expire for any jobs created on or after January 1, 2025. In order to claim the PPE Credit, the PPE manufacturer must be qualified to claim the Georgia Jobs Tax Credit, based on the monthly average of qualifying jobs created and maintained in a taxable year.[xii] The additional credit amount is applied to qualifying jobs where 50% or more of the time during a month is spent specifically on the qualifying activity of manufacturing PPE in the state. A business must also be a "PPE manufacturer,"[xiii] which is engaged in the manufacturing of PPE in the state, meaning a portion of its employees in the state are manufacturing PPE. This may apply to businesses that began manufacturing PPE as a response to COVID-19.

US C&I recent developments

As part of the Consolidated Appropriations Act of 2021, the Work Opportunity Tax Credit ("WOTC") was extended for five (5) years and is now set to expire on December 31, 2025.[xiv] WOTC is a federal income tax credit for organizations that hire and retain qualified individuals who are in an eligible targeted category.[xv] Credit is generally worth up to $2,400 per eligible individual. However, the credit can be worth up to $9,600 per employee for those who qualify under specific targeted groups. Historically, the WOTC credit has only been extended in one- or two-year increments. It may be a more attractive opportunity for many businesses now that it is available for the next five years. Recent legislation also extended the Federal Empowerment Zone program for five years, and the Indian Employment Credit and Disaster Relief Tax Credits for one year.[xvi;xvii]

Some states, such as New Jersey, have rolled out new programs during 2020 to stimulate economic recovery. The New Jersey Economic Recovery Act of 2020 was signed into law on January 7, 2021, creating a suite of new economic development incentive programs and modifying certain legacy programs.[xviii] Below are three examples of new programs created by the recent law.

The New Jersey Emerge Program ("Emerge") is a new incentive that provides corporate income tax credits for job creation and capital investment in the state. Large job retention projects may also be eligible in limited circumstances. Tax credits may range in value between $500 and $8,000 per qualified new job per year for a period of up to seven years. Emerge provides for larger benefits based primarily on location within New Jersey, business activity, and other bonus criteria.[xix]

In addition, the new legislation created the New Jersey Aspire Program ("Aspire"), designed to encourage commercial and residential development projects by providing awards to close project financing gaps. Under Aspire, developers may obtain up to 45% of project costs in the form of tax credits for eligible projects. Maximum award amounts are capped at $32M or $50M per project, depending on location.[xx]

The Brownfields Redevelopment Incentive Program was also created to assist developers, by allowing for the offset of a portion of remediation costs through tax credits. The credits cover the lesser of 40% of eligible remediation costs or $4M for each project.[xxi]

Most of New Jersey's new programs are discretionary with the need for approval at a public hearing. However, once approved, applicants may receive lucrative tax credit awards that can typically be sold for at least 85% of their value.[xxii] This feature makes these programs attractive to almost any type of company with an eligible project, including those that do *not* have a tax liability in the state.

Importance of understanding C&I details and context

With the amount of investment involved in expanding in the United States, it is *not* surprising that site selection, infrastructure assessments, and labor studies require significant effort. Therefore, understanding and evaluating incentives should be no less important. The variety of state and local incentives vary dramatically from state to state. Companies should strive to understand the performance requirements, application deadlines, and the potential impacts in each state where they are considering investing.

To illustrate the importance of understanding C&I utilization, consider an inbound company acquiring a target with tax credit carryforwards. During due diligence the acquiring company should confirm the incentives were certified, obtained, and in compliance. In addition, the company should project the tax liability in order to monetize the credits. In some cases, tax credits can be sold or refunded but in other cases, if their value exceeds liability and the excess credits cannot be carried forward (due to legal restrictions or timing), then the credits may expire and become worthless.

C&I in the post-COVID-19 world

As economies continue to recover after the onset of the COVID-19 pandemic, C&I may well play an increasingly important role for inbound investment in 2021 and beyond. Many companies may be looking for more socially distanced spaces and reevaluating whether their higher cost locations are necessary as more of their employees work from home. As governments reevaluate their economic development toolboxes, we anticipate new C&I policies to help support companies as they navigate the economic impacts of COVID-19 recovery.

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March 30
1:00 p.m. ET

Dbriefs webcast: OECD’s transfer pricing guidance on COVID-19: Practical applications
URL: https://www2.deloitte.com/us/en/events/tax-executives-dbriefs-webcasts/2021/oecds-transfer-pricing-guidance-on-covid-19-practical-applications.html

March 31
1:00 p.m. ET

Dbriefs webcast: Financial accounting and reporting for income taxes: Important updates
URL: https://www2.deloitte.com/us/en/events/tax-executives-dbriefs-webcasts/2021/financial-accounting-and-reporting-for-income-taxes.html

Upcoming activities

April 29
1:00 p.m. ET

Dbriefs webcast: Tax year 2020 international tax compliance: How are you tracking?
URL: https://www2.deloitte.com/us/en/events/tax-executives-dbriefs-webcasts/2021/tax-year-2020-international-tax-compliance.html

Endnotes

i. Regulations may impose a shorter deadline (see Treas. Reg. §§ 1.882–4(a)(3) and 1.874–1(b)), but courts have differed on their validity. Compare the Court of Appeals decision in *Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. 2008) (regulations are valid) with the Tax Court decision it reversed, 126 T.C. 96 (regulations are invalid). The Tax Court decision discussed in this article declined to address regulatory issues.
ii. See section 6020(b)(1) and Treas. Reg. § 301.6020–1(b)(2).
iii. 154 T.C. 37 (2020). We expect that the 2020 decision will come to be known as "*Adams Challenge I*," and the decision discussed in this article will be known as "*Adams Challenge II*."
iv. World Bank Group, "Foreign direct investment, net inflows (BoP, current US$)," https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?view=map, accessed March 24, 2021.
v. Bureau of Economic Analysis, "Foreign Direct Investment in the US: Balance of Payments and Direct Investment Position Data," https://www.bea.gov/international/di1fdibal, accessed March 24, 2021.
vi. Bureau of Economic Analysis, "New Investment in the United States by Foreign Direct Investors," https://www.bea.gov/international/di1fdinew, accessed March 24, 2021.
vii. American Rescue Plan Act of 2021, Title IX, Subtitle G, Part 6, SEC. 9651.
viii. Tax News & Views Capitol Hill briefing. March 5, 2021, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-taxnewsandviews-210305.pdf.
ix. Coronavirus Aid, Relief, and Economic Security Act or the "CARES Act," Title I, SEC. 1102.
x. PPP Loan Forgiveness - U.S. Small Business Administration, https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/ppp-loan-forgiveness.
xi. Ga. Comp. R. & Regs. R. 560-7-8-.66.
xii. Ga. Comp. R. & Regs. R. 110-9-1-.03.
xiii. Ga. Comp. R. & Regs. R. 560-7-8-.66 (2) (d).
xiv. Consolidated Appropriations Act, 2021, P.L. 116–260, Division EE, Title I, Subtitle A, SEC. 113.
xv. Work Opportunity Tax Credit - IRS, https://www.irs.gov/businesses/small-businesses-self-employed/work-opportunity-tax-credit & https://www.irs.gov/instructions/i5884.
xvi. Taxpayer Certainty and Disaster Tax Relief Act of 2020, 2021 Consolidated Appropriations Act, H.R. 133
xvii. US Multistate Tax Alert, December 27, 2020, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-taxpayer-certainty-and-disaster-tax-relief-act-of-2020-extends-wotc-federal-empowerment-zones-and-indian-employment-credit.pdf
xviii. New Jersey Economic Recovery Act of 2020, A4, P.L.2020, c.156.
xix. New Jersey Economic Recovery Act of 2020, A4, P.L.2020, c.156. §68..
xx. New Jersey Economic Recovery Act of 2020, A4, P.L.2020, c.156. §54.
xxi. New Jersey Economic Recovery Act of 2020, A4, P.L.2020, c.156 §9
xxii. New Jersey Economic Recovery Act of 2020, A4, P.L.2020, c.156 §24 (2)..

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