

State Bar of Texas
19th Annual International Tax Symposium

Dallas – November 3, 2016
Houston – November 4, 2016

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19th Annual International Tax Symposium
Dallas-November 3, 2016 • Houston-November 4, 2016
CLE Hours 7.0 • Course Number 901359829
CPE Hours 8.0 • Sponsor ID #135

8:00-8:45 Registration/Breakfast 8:45-9:30 IC-DISC [.75 CLE/1.0 CPE] Robert J. Misey, Jr., Reinhart Boerner, Milwaukee, WI <i>Many tax attorneys are familiar with the use of IC-DISCs to convert the ordinary income of a flow-through entity into a qualified dividend. This session focuses on advanced structuring techniques, such as IC-DISCs owned by a trust or by a foreign parent.</i> 9:30-10:30 OVPD Streamlined Compliance Update [1.0 CLE/1.0 CPE] Daniel Price, Internal Revenue Service, Austin, TX Austin Carlson, Gray Reed & McGraw Houston, TX Jason Freeman, Freeman Law PLLC, Dallas, TX Panel with Mr. Price, Mr. Carlson and Mr. Freeman <i>This panel discussion will provide an overview and update of offshore compliance options offered by the Internal Revenue Service to U.S. taxpayers, thereby assisting practitioners in choosing the best option for their clients to come into compliance with income tax and FBAR reporting obligations. The panelists will provide their perspective from both a tax practitioner and IRS point of view on the future of the OVPD and offshore disclosure options.</i> 10:30-10:45 Break 10:45-11:30 Traps and Pitfalls of the New Section 385 Regulations [.75 CLE/1.0 CPE] Bret Wells, The University of Houston Law Center, Houston, TX <i>This presentation will provide an analysis of the proposed Section 385 regulations. The Treasury Department has signaled that aspects of these regulations will be further revised, and the presentation will discuss these aspects of the current proposed regulations.</i> 11:30-11:45 Lunch Break 11:45-12:30 Oil and Gas Tax in Mexico [.75 CLE/1.0 CPE] Todd Lowther, Thompson & Knight, Houston, TX John Cohn, Thompson & Knight, Houston, TX Michiel Schul, Loyens & Loeff (Houston only) <i>This presentation will cover the international structuring of investment in Mexico energy, with consideration of bilateral investment treaties and income tax treaties.</i>	12:30-12:45 Post-Lunch Break 12:45-1:45 International Tax Law Update [1.0 CLE/1.0 CPE] Adam Halpern, Fenwick & West Mountain View, CA <i>This session will focus on issues of recent importance in the U.S. federal international tax arena, including review and analysis of legislative, administrative, and judicial developments.</i> 1:45-2:00 Break 2:00-2:45 Transfer Pricing Update and Country-by-Country Reporting [.75 CLE/1.0 CPE] William Byrnes, Texas A&M University School of Law, Fort Worth, TX <i>This session will cover recent updates to transfer pricing and Country-By-Country Reporting on IRS Form 8975.</i> 2:45-3:30 Structuring Inbound Investments into the U.S. [.75 CLE/1.0 CPE] Willie Hornberger, Jackson Walker, Dallas, TX <i>This session will cover structuring cross-border acquisitions and dispositions of U.S. and non-U.S. entities.</i> 3:30-3:45 Break 3:45-4:15 Taxes Eligible for the Foreign Tax Credit [0.5 CLE/0.5 CPE] Ben Vesely, BDO, Dallas, TX <i>This session will cover the basic rules relating to creditability of foreign taxes for US taxpayers as well as additional considerations, traps and opportunities that may arise in this area. The session will also highlight some examples of non-creditable taxes as well as some recent developments in local jurisdictional taxes that may cause specific issues when trying to be used as credits in the US.</i> 4:15-5:00 Current Developments in International Estate Planning [0.75 CLE/0.5 CPE] John Strohmer, Crady Jewett McCulley, Houston, TX <i>This presentation will cover the newest reporting obligations that will soon be here for international individuals. Form 708 will be filed by U.S. residents who receive gifts from Covered Expatriates, and Form 5472 will soon need to be filed by non-residents who own a U.S. entity that is disregarded for U.S. tax purposes.</i> 5:00-7:00 Reception

2016 INTERNATIONAL TAX SYMPOSIUM TAX SECTION OF THE STATE BAR OF TEXAS

November 3-4, 2016

EVALUATION FORM

Rating Scale: 5=Excellent 4=Very Good 3=Good 2=Fair 1=Poor

PROGRAM & SPEAKERS:

- **8:45 a.m.** **IC-DISC**
Robert J. Misey, Jr., Reinhart Boerner, Milwaukee, WI

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Comments:

- **9:30 a.m.** **OVDP Streamlined Compliance Update**
Daniel Price, Internal Revenue Service, Austin, TX
Austin Carlson, Gray Reed & McGraw, Houston, TX
Jason Freeman, Freeman Law PLLC, Dallas, TX

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Comments:

- **10:45 a.m.** **Traps and Pitfalls of the New Section 385 Regulations**
Bret Wells, The University of Houston Law Center, Houston, TX

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Comments:

- **11:45 a.m. Oil and Gas Tax in Mexico**
Todd Lowther, Thompson & Knight, Houston, TX
John Cohn, Thompson & Knight, Houston, TX
Michiel Schul, Loyens & Loeff (Houston Only)

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Comments:

- **12:45 p.m. International Tax Law Update**
Adam Halpern, Fenwick & West, Mountain View, CA

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Comments:

- **2:00 p.m. Transfer Pricing Update and Country-by-Country Reporting**
William Byrnes, Texas A & M University School of Law, Fort Worth,
TX

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Comments:

- **2:45 p.m. Structuring Inbound Investments into the U.S**
Willie Hornberger, Jackson Walker, Dallas, TX

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Comments:

3:45 p.m. Taxes Eligible for the Foreign Tax Credit
Ben Vesely, BDO, Dallas, TX

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Comments:

4:15 p.m. Current Developments in International Estate Planning
John Strohmeyer, Crady Jewett McCulley, Houston, TX

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Comments:

GENERAL COMMENTS:

1. The quality of my lunch experience was:

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Comments:

2. The meeting facility was:

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Comments:

3. Do you have any suggestions for improving the Tax Section's International Tax Symposium for next year?

Comments:

4. What did you consider the most beneficial aspect of the program?

Comments:

5. What did you consider the least beneficial aspect of the program?

Comments:

6. What topics would you like to see at the Tax Section's International Tax Symposium program next year? Please check all that apply.

- ☐ K-1 Disclosures for International Tax Items and Issues.
- ☐ International Value Added Tax (VAT) for U.S. Businesses.
- ☐ A Short Guide to Understanding Foreign Reporting Issues.
- ☐ Pre-Arrival Tax Planning.
- ☐ Accounting for Foreign Real Estate Holdings by U.S. Persons.
- ☐ FIRPTA Withholding and Other Complications on the Sale of Real Estate.
- ☐ Outbound U.S. Income Tax Considerations
- ☐ Understanding Form 8621
- ☐ Divorce Across International Borders.
- ☐ The Portfolio Interest Exception
- ☐ Dealing With International Clients: When It Goes From Civil To Criminal.
- ☐ Cross-Border Tax: Canada/U.S.
- ☐ Cross-Border Tax: Mexico/U.S.
- ☐ U.S. Taxation of Foreign Retirement and Pension Plans.
- ☐ FATCA and the Common Reporting Standard.
- ☐ From PFIC to CFC: The Evolution of Shareholder Filing Requirements on Form 8621 and 5471.

Do you have any other suggestions for next year's programming?

7. Do you have any additional comments you would like to share?

Comments:

Your comments are important. Thank you for taking the time to complete this evaluation form.

IC-DISCs: Structuring to Maximize Benefits

By Robert J. Misey, Jr.
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I. INTRODUCTION TO THE IC-DISC

A. Formation of the IC-DISC.

1. The IC-DISC must be a U.S. corporation with a single class of stock.¹
2. The IC-DISC stock must have a minimum par value of \$2,500.²
3. The U.S. corporation elects to be an IC-DISC by filing a Form 4876-A.³
 - (a) For an existing corporation to elect IC-DISC status, the Form 4876-A must be filed during the 90 days preceding the first day of the corporation's taxable year.
 - (b) For a newly-formed corporation, the Form 4876-A must be filed within 90 days after the beginning of the corporation's first taxable year.

B. Taxation of an IC-DISC and Its Shareholders.

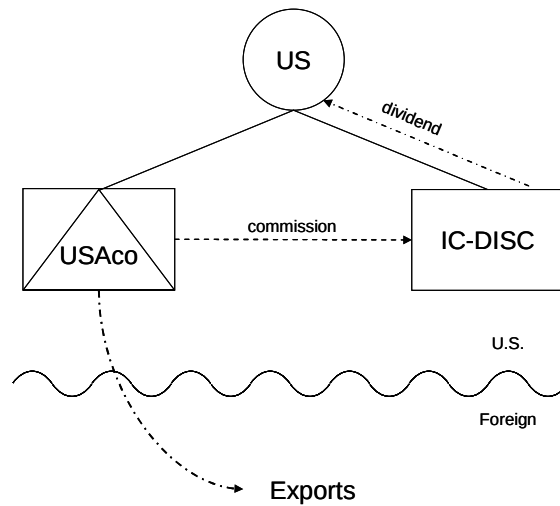
1. An IC-DISC is not subject to the regular U.S. corporate income tax.⁴ As a result, the IC-DISC does not pay tax on the commission received from the manufacturing entity.
 - (a) When the IC-DISC pays a dividend to its owners, the owners will pay tax at a 20% rate. In effect, the owners are converting a 40% tax on income representing the amount of the commission to a 20% individual tax.
 - (b) If the manufacturing entity is a flow-through entity, such as an S corporation, partnership, or most limited liability companies ("LLCs"), the reduction in tax is twenty percentage points.⁵

- (c) If the manufacturing entity is a C corporation, the reduction in tax is 28 percentage points.⁶
- 2. Although the IC-DISC itself is not a taxable entity, the IC-DISC's U.S. shareholders are subject to tax on deemed dividend distributions from the IC-DISC.⁷ These deemed distributions do not include commissions earned on the first \$10 million of the IC-DISC's qualified export receipts each year.⁸ Anything beyond the \$10 million threshold is deemed distributed.
- 3. The IC-DISC was designed as a means by which a U.S. exporter could borrow funds from the U.S. Treasury at a low interest rate.
 - (a) More specifically, the U.S. shareholder must pay an interest charge on its IC-DISC-related deferred tax liability, which equals the difference between the shareholder's tax for the taxable year computed first with, and then without, the accumulated IC-DISC income of the shareholder that has been deferred.⁹
 - (b) Nevertheless, if the IC-DISC distributes cash representing all of its income, the interest charge is inapplicable.
- 4. As a practical matter, because the rate of tax on qualified dividends is only 20%, individual owners of the IC-DISC should want to take a dividend as soon as possible.
- 5. Does the Net Investment Income tax of 3.8% apply to dividends from an IC-DISC?¹⁰

II. THE TESTS TO QUALIFY AS AN IC-DISC

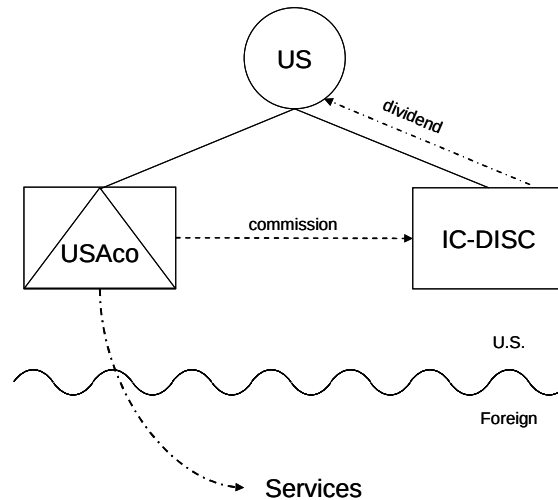
- A. To qualify as an IC-DISC, the domestic corporation must pass both the qualified export receipts and qualified export assets tests.
- B. The qualified export receipts test states that 95% of the gross receipts of the IC-DISC must constitute qualified export receipts.¹¹
 - 1. Qualified export receipts include gross receipts from sales of export property, rents for the use of export property outside the United States, services related to export sales, engineering or architectural services for construction projects located abroad, and commissions thereon.

Example 1: Uncle Sam wholly-owns USAco, an S corporation that manufactures widgets. Due to burgeoning export sales, Uncle Sam forms an IC-DISC whose only activity results in receiving commissions on qualified export receipts. Because 100% of the IC-DISC's gross receipts constitute qualified export receipts, the IC-DISC satisfies the gross receipts test.



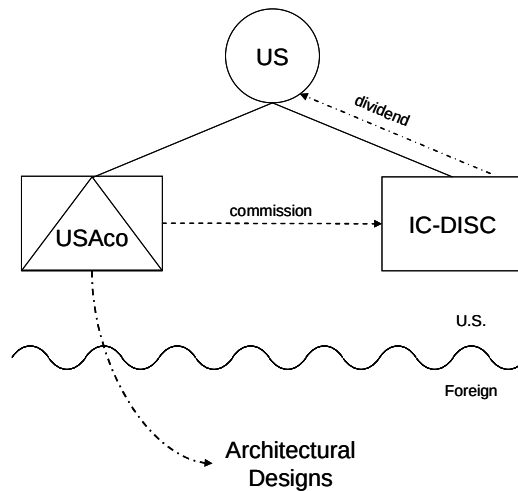
2. Services related to export sales include, but are not limited to, warranty services, maintenance services, repair services, installation services, and even some transportation services.

Example 2: USAco, an S corporation that manufactures and exports widgets, also sells maintenance service contracts for widgets to those same foreign customers. The gross receipts from those maintenance service contracts constitute qualified export receipts.



3. The receipts for engineering or architectural services for construction projects must be with respect to projects located outside of the United States.

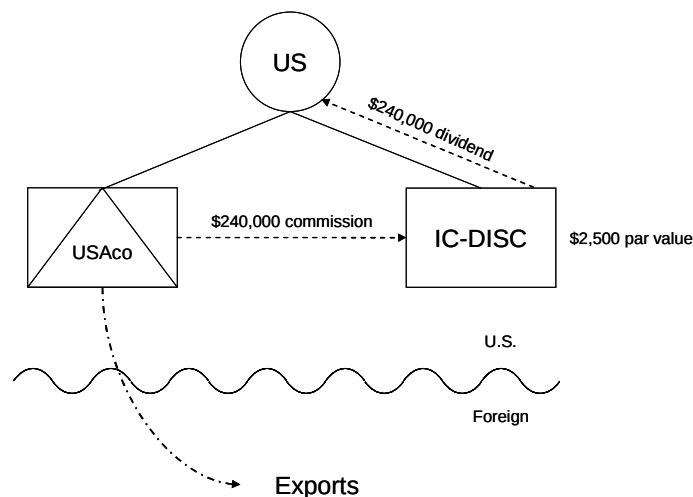
Example 3: Uncle Sam wholly-owns USAco, an S corporation that is an architectural firm. USAco's specialty is designing drive-in wedding chapels that are built in Europe. The receipts from the designs constitute qualified export receipts.



C. The qualified export assets test states that 95% of the assets of the IC-DISC must be qualified export assets.¹²

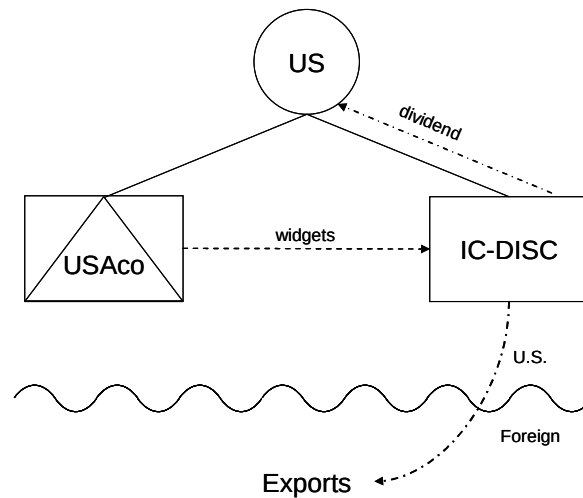
1. Qualified export assets include accounts receivable, temporary investments, export property, and loans to producers.¹³
2. Temporary investments must be reasonably necessary to meet the requirements of the IC-DISC and include working capital. For a simply-structured, commission-based IC-DISC, the qualified export assets would typically include the \$2,500 of cash paid in as par value for the stock as working capital.

Example 4. Uncle Sam wholly-owns USAco, an S corporation that manufactures widgets. Uncle Sam capitalizes an IC-DISC with \$2,500 of cash and the IC-DISC receives a commission during the year of \$240,000 that is put in a checking account before being distributed on the last day of the year as a dividend. Because the \$2,500 cash remaining constitutes working capital to meet the needs of potential creditors, the \$2,500 is a temporary investment and 100% of the IC-DISC's assets constitute qualified export assets. Consequently, the IC-DISC passes the qualified export assets test.



3. Although buy-sell IC-DISCs are not as common as commission-based IC-DISCs, the export property as inventory of a buy-sell IC-DISC (and accounts receivable) constitutes a qualified export asset.

Example 5: Uncle Sam wholly-owns USAco, an S corporation that manufactures widgets. Due to burgeoning export sales, Uncle Sam forms an IC-DISC, which acts as a buy-sell IC-DISC—buying widgets from USAco and selling them to foreign customers. Assuming that the widgets constitute export property, any widgets remaining in inventory at year end constitute qualified export assets and 100% of the IC-DISC's assets constitute qualified export assets. Consequently, the IC-DISC passes the qualified export assets test.



4. Producer loans (and any interest generated) constitute a qualified export asset.

III. QUALIFICATION AS EXPORT PROPERTY

A. General Background.

1. Because most of the qualified export receipt categories focus on export property, satisfying the definition of export property is critical.
2. There are three requirements for an IC-DISC to receive income from a sale of export property:¹⁴
 - (a) the property must be manufactured, produced, grown or extracted in the United States by a person other than the IC-DISC;

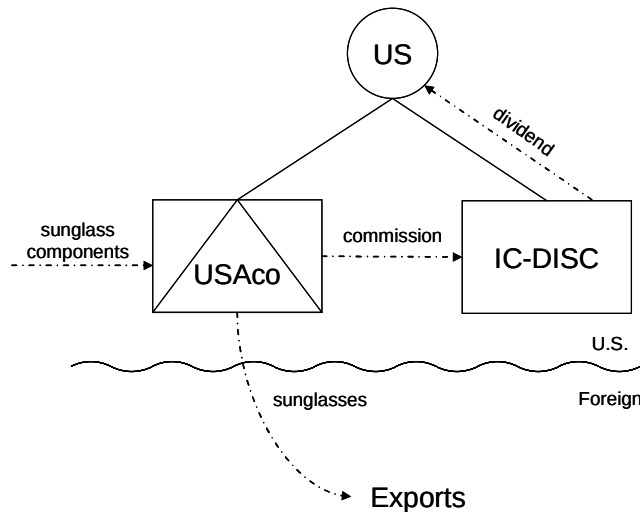
- (b) the export property must be held primarily for sale, lease or rental for direct use, consumption, or disposition outside the United States; and
 - (c) the export property must have a maximum of 50% foreign content.
3. Although exporters often think of newly manufactured property as export property, the property can be used equipment or even scrap.

B. The Manufacturing Requirement.

- 1. The export property must be manufactured in the United States. However, the IC-DISC may not manufacture the export property.
- 2. Property is manufactured within the United States if either (a) conversion costs incurred in the United States constitute 20% of the cost of goods sold, (b) there is a substantial transformation in the United States, or (c) the operations in the United States are generally considered to constitute manufacturing.¹⁵
- 3. The conversion costs include direct labor and factory burden, including packaging and assembly.
- 4. A substantial transformation would include, for example, the conversion of wood pulp to paper or the canning of fish.
- 5. The case law is somewhat vague regarding what is generally considered to constitute manufacturing.
 - (a) In *General Electric v. Commissioner*,¹⁶ the issue was whether assembling jet engines onto planes constituted manufacturing.
 - (b) The Second Circuit Court of Appeals stated that the taxpayer did not conduct manufacturing, finding that: (i) the airplane industry recognizes aircraft and engines as legally distinct and separate products; and (ii) affixing a completed product to another does not constitute manufacturing.

Example 6: USAco separately purchases the frames, wings, tinted lenses, and little screws that can be combined to make sunglasses. USAco pays minimum wages to 11th grade dropouts who put together approximately 20 sunglasses each hour. Assuming that these conversion costs are less than 20% of the costs of goods sold and there is a not a substantial

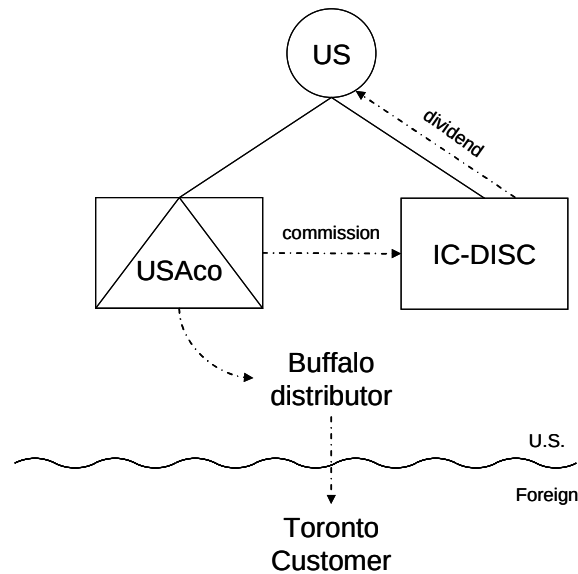
transformation of the sunglass components in the sunglasses, manufacturing is satisfied only if this process is generally considered to constitute manufacturing.



C. The Destination Requirement.

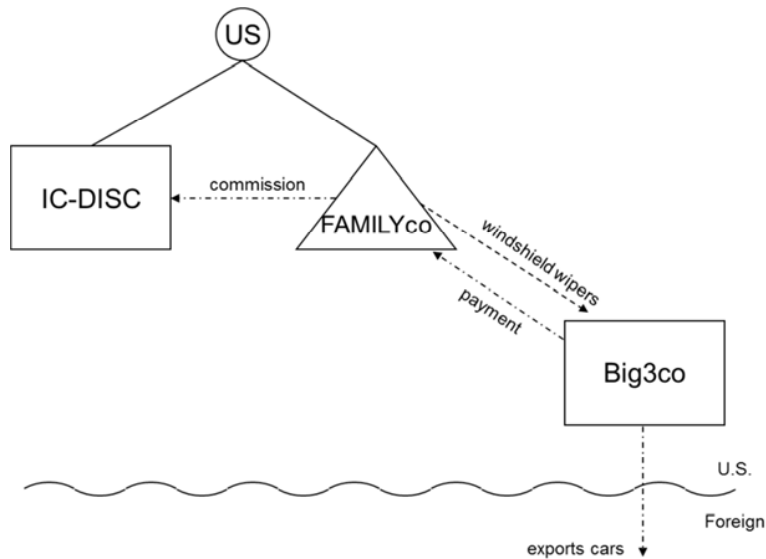
1. The export property must satisfy a destination test, which requires being held for sale, lease or rental in the ordinary course of business for direct use, disposition or consumption outside the United States.¹⁷
 - (a) Property satisfies the destination test if it is delivered to a freight forwarder for ultimate shipment abroad.¹⁸
 - (b) Property also satisfies the destination test if it is sold to a customer in the United States, provided the property does not undergo further manufacturing by the purchaser prior to export, and the property is shipped to a foreign destination within one year.¹⁹
2. Under the destination test, what may seemingly be domestic sales could qualify as export sales.

Example 7: USAco sells widgets to a widget distributor in Buffalo, New York. One of the Buffalo distributor's biggest customers is a Toronto-based company. If properly documented, the widgets re-sold by Buffalo distributor to a Toronto-based company satisfy the destination test.

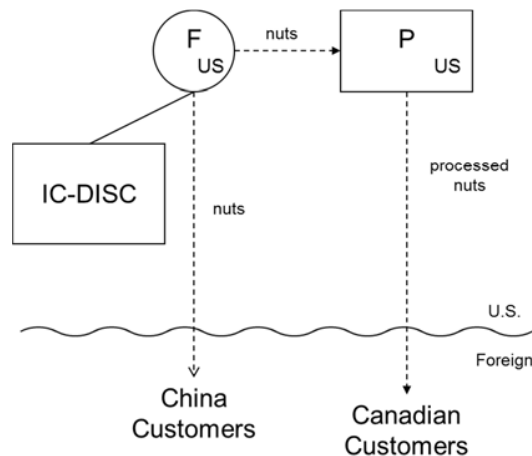


- (a) The purchasers of an exporter's product will have to provide the exporter with information showing that the product was exported and, if the domestic purchasers cooperate, the IC-DISC can benefit from these sales.
 - (b) The U.S. purchaser will have to provide the IC-DISC with documentation of ultimate shipment outside the United States, which may include, *inter alia*, a copy of the export bill of lading, the shipper's export declaration or other information that satisfies the IRS.
3. At the same time, seemingly export sales could be domestic sales.
 4. The export of property by a customer does not satisfy the destination test if the customer itself conducts manufacturing. As with the manufacturing requirement, whether further manufacturing is conducted by the customer is often a question of fact.

Example 8: FAMILYco, a closely-held LLC, manufactures windshield wipers in the United States with U.S. materials. FAMILYco, through its IC-DISC, sells its windshield wipers to Big3co, a Detroit auto manufacturer, which affixes the windshield wipers to its new automobiles that are exported to Canada. The IC-DISC can benefit from the sale of its windshield wipers to Big3co only if affixing windshield wipers to automobiles is not further manufacturing.



Example 9: Farmer grows nuts, some of which he exports directly to customers in China. Farmer sells the other nuts to a Processor that shells the nuts before Processor sells them to Canadian customers. Although Farmer has sold qualified export property to China, the Processor has conducted further manufacturing on the nuts sold to Canadian customers.



5. Sales to a foreign subsidiary can satisfy the destination test. However, only the sale by the exporter (and not by its foreign subsidiary) qualifies.

D. The Maximum of 50% Foreign Content Requirement.

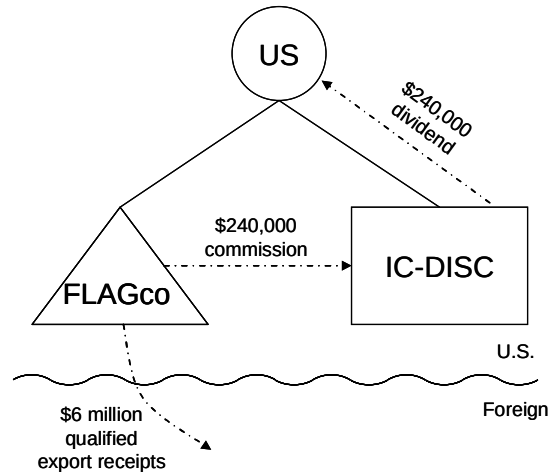
No more than 50% of the fair market value of export property may be attributable to the fair market value of articles imported into the United States. The fair market value of the foreign content is determined by the dutiable value of any foreign components.²⁰

IV. DETERMINING THE IC-DISC BENEFIT

- A. The commission of an IC-DISC from sales of export property is in an amount constituting as much as the greater of:
1. 4% of the qualified export receipts,²¹
 2. 50% of the combined taxable income,²² or
 3. the arm's length amount determined under the transfer pricing principles of section 482.²³
- B. Very few taxpayers determine the IC-DISC's income using the transfer pricing principles of section 482 because IC-DISCs generally have little economic activity and, consequently, lower income under those principles than under the other two methods.
- C. These methods to determine the IC-DISC's income apply regardless of whether the IC-DISC is a "commission" IC-DISC or a "buy-sell" IC-DISC.²⁴ Any of these transfer pricing methods for the IC-DISC combined with the 20% rate of tax on dividends from domestic corporations to U.S. individual shareholders create tremendous tax savings from this export benefit.
- D. The qualified export receipts method allocates 4% of the qualified export receipts from the export sales to the IC-DISC.

Example 10: Betsy Ross, a U.S. citizen owns FLAGco, a single-member LLC that is disregarded for U.S. tax purposes. FLAGco has qualifying export sales of \$6 million of flags through its IC-DISC as its only gross receipts. Using 4% of the qualified export receipts method, FLAGco will deduct a commission paid of \$240,000 of gross receipts, resulting in a U.S. tax reduction of \$96,000 (40% of \$240,000). If FLAGco's IC-DISC distributed the cash representing this income as a dividend to Betsy Ross, Betsy Ross would pay U.S. tax of \$48,000 (\$240,000 at a 20% capital gains rate on the qualified dividend). As a result, the impact of the 4% of

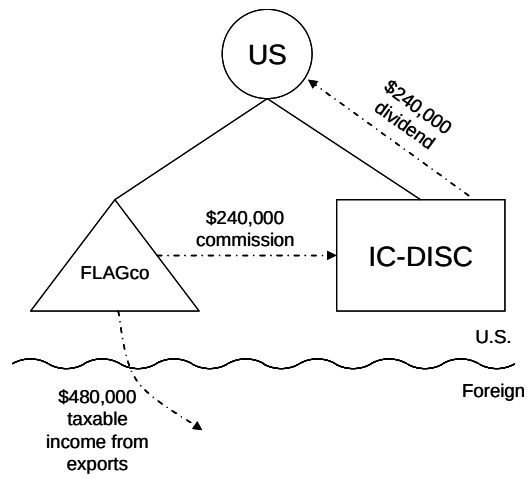
qualified gross receipts method combined with the 20% tax rate is a tax savings of \$48,000 (\$90,000 less \$48,000). The tax savings would be even greater if FLAGco were a C corporation because, but for the IC-DISC, the earnings representing the commission would still be in corporate solution.



- E. The combined taxable income method allocates 50% of the taxable income from the export sales to the IC-DISC.

Example 11: Betsy Ross owns FLAGco, a single-member LLC that is disregarded for U.S. tax purposes. FLAGco's only taxable income is \$480,000 from the export of flags through its IC-DISC (\$6 million of exports, \$5 million of cost of goods sold and \$520,000 of operating expenses). Using the 50% of combined taxable income method, FLAGco pays and deducts \$240,000 as a commission to its IC-DISC, which results in tax on only the \$240,000 of remaining taxable income, which would be \$96,000 (40% of \$240,000). If the IC-DISC distributes the \$240,000 of cash representing the commission as a dividend to Betsy Ross, that \$240,000 would be subject to tax of \$48,000 (the 20% capital gains rate on the qualified dividend of \$240,000). The individual tax of \$48,000 and FLAGco's tax on its remaining \$240,000 of \$96,000 totals \$144,000, which is \$48,000 less than the \$192,000 if FLAGco had operated without the IC-DISC. The tax savings would be even greater if FLAGco were a C corporation because, but for the IC-DISC, the earnings

representing the commission would still be in corporate solution.



V. MAXIMIZING THE IC-DISC'S INCOME

A. An exporter can use any of the methods described in the previous section to achieve the greatest IC-DISC income possible.

1. As a simple rule of thumb, the combined taxable income method results in the largest IC-DISC income when exports have a net pre-tax margin of 8% or greater (producing a benefit of approximately \$100,000 for every \$1 million of combined taxable income).
2. On the other hand, the qualified export receipts method provides the largest IC-DISC income when the net pre-tax margin is less than 8% (producing a benefit of approximately \$8,000 for every \$1 million of qualified export receipts).
3. The IC-DISC rules permit the use of different methods to different sales based on product lines, recognized industry or trade usage, and even by transaction.²⁵
4. In practice, most of the decisions will be between the qualified export receipts and combined taxable income methods.
5. If the net pre-tax margin on exports is lower than worldwide net pre-tax margins, which often occurs due to the extra shipping and administrative expenses of foreign sales, the marginal costing of combined taxable income may result in the largest commission.
6. The exporter can maximize the IC-DISC's income by ignoring loss sales.²⁶

B. Grouping.

1. Grouping refers to the exporter's maximizing the IC-DISC's commission by separating the high-margin sales from the low-margin sales.

Example 12: VinCo, an S corporation, exports domestically produced beer and wine. The annual gross receipts and combined taxable income from these export sales are as follows:

	<i>Gross receipts</i>	<i>Combined taxable income</i>	<i>Net pre-tax margin</i>
Beer	\$ 5,000,000	\$1,000,000	20%
Wine	<u>\$ 5,000,000</u>	<u>\$ 200,000</u>	4%
Total export sales	<u>\$10,000,000</u>	<u>\$1,200,000</u>	12%

Through product grouping, VinCo can use the 50% of combined taxable income method for sales of beer, which allocates \$500,000 [50% of \$1,000,000] to the IC-DISC. At the same time, VinCo can use the 4% of qualified export receipts method for sales of wine, which excludes \$200,000 [4% of \$5,000,000]. The total amount of the IC-DISC's income is \$700,000.

2. Exporters have considerable flexibility in grouping.
 - (a) An exporter's product or product line groupings will be accepted if the groupings conform to recognized trade or industry usage or the two-digit major groups (or inferior classifications) of Standard Industrial Classification codes.²⁷
 - (b) In addition, within the same taxable year, an exporter can use grouping for one product line and the transaction-by-transaction method for another product line.²⁸

C. Marginal Costing.

1. A second technique for increasing the IC-DISC's income is marginal costing.²⁹ Under the general rule, combined taxable income equals the excess of the qualified export receipts over the total direct and indirect costs related to exports.³⁰
 - (a) If the exporter elects marginal costing, however, only marginal costs (e.g., direct costs) are taken into account in computing combined taxable income.

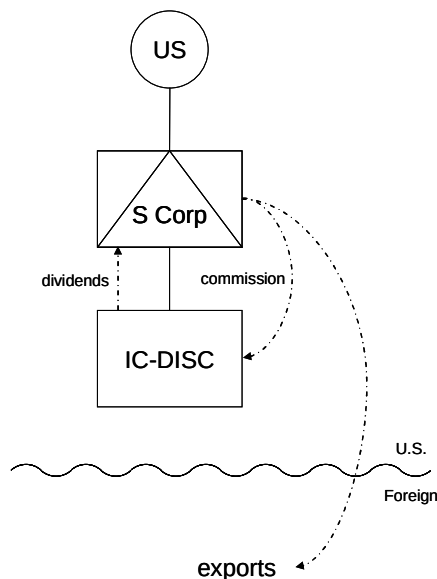
- (b) Therefore, marginal costing allows a taxpayer to increase combined taxable income by excluding the fixed costs related to export sales.
 - (c) Marginal costs include only the direct material and direct labor costs.
 - (d) All other costs, such as selling, general, administrative, and even interest expenses are ignored for purposes of computing combined taxable income.³¹
 - (e) A requirement for the use of marginal costing states that the amount of combined taxable income under marginal costing must be greater than that under a full costing approach.³²
2. An overall profit percentage limitation restricts the combined taxable income of an exporter to an amount equal to qualified export receipts multiplied by the ratio of full costing combined taxable income from all sales (domestic and foreign) to total receipts from all sales (domestic and foreign).³³

D. Expense Allocations.

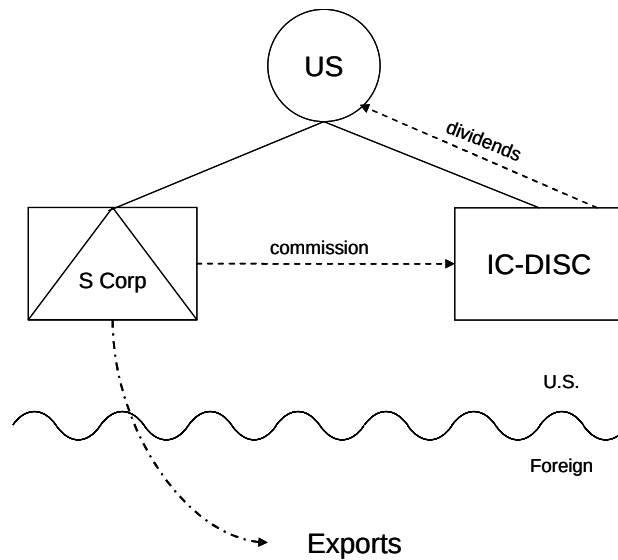
1. A third technique for increasing the IC-DISC's income is expense allocations.
2. As discussed above, combined taxable income equals the excess of qualified export receipts over the total costs of the exporter, which includes deductions that are definitely related to export sales (e.g., cost of goods sold) and a ratable portion of any deductions that are not definitely related to any specific class of gross income (e.g., interest expense and selling, general, and administrative expenses).³⁴
3. A taxpayer can increase combined taxable income and, in turn, the amount of its IC-DISC's income, by developing defensible apportionment bases that allocate fewer deductions against qualified export receipts.³⁵

VI. STRUCTURING THE IC-DISC

- A. An IC-DISC may either be a subsidiary of a flow-through entity or a brother-sister entity of a flow-through entity.
1. IC-DISC as a subsidiary of an S corporation or another flow-through entity.

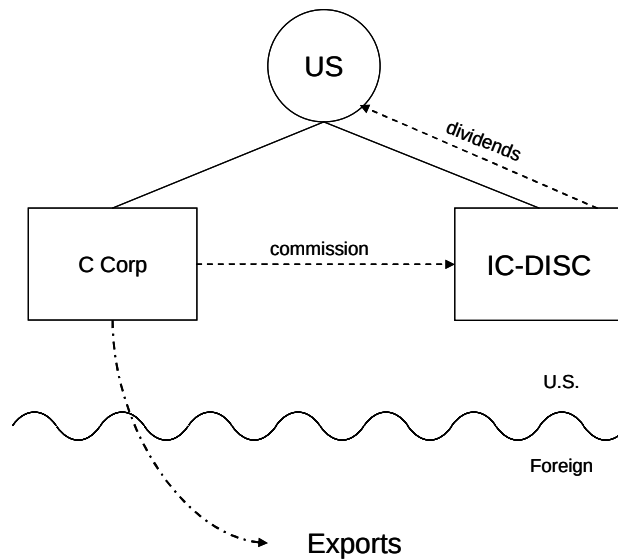


2. IC-DISC as a brother-sister entity of an S corporation or another flow-through entity.



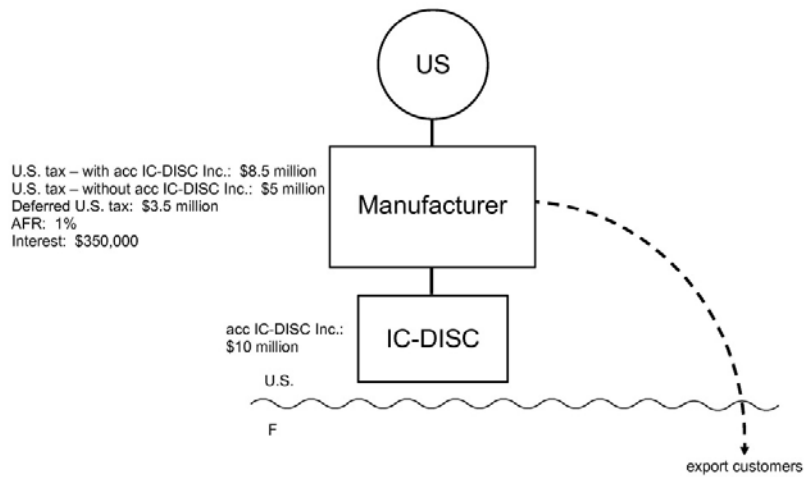
- B. An IC-DISC should only be a brother-sister entity of a C corporation.

1. IC-DISC as a brother-sister entity of a C corporation.

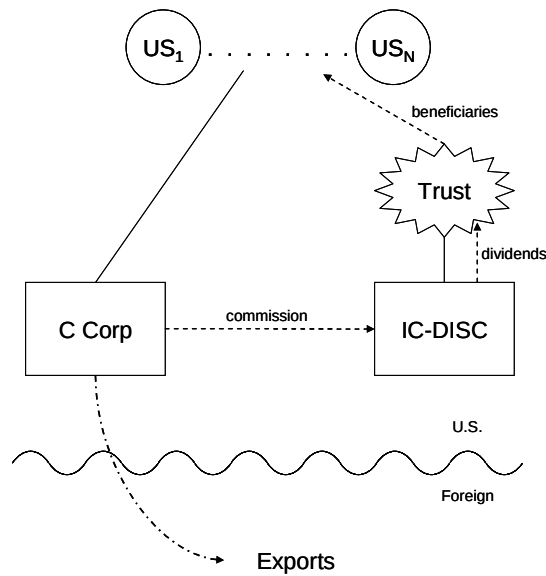


2. An IC-DISC should not be the subsidiary of a C corporation because the C corporation is not entitled to a dividends received deduction when receiving the dividend from the IC-DISC.³⁶

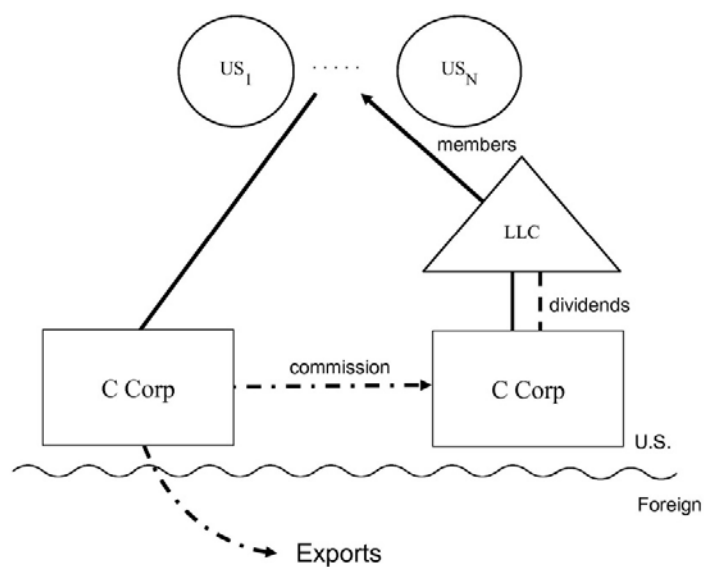
3. An IC-DISC as a subsidiary of a C corporation only works for deferral.



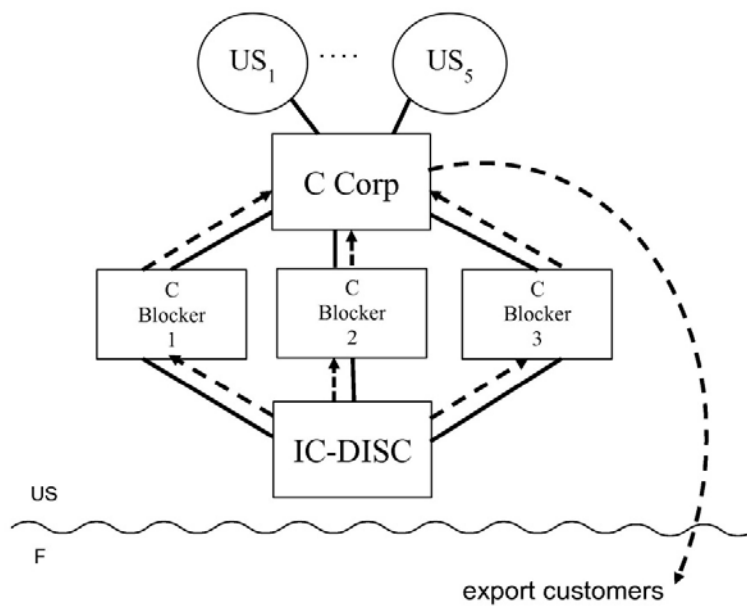
4. If shares of a C corporation are commonly sold, a trust could own the shares of the IC-DISC.



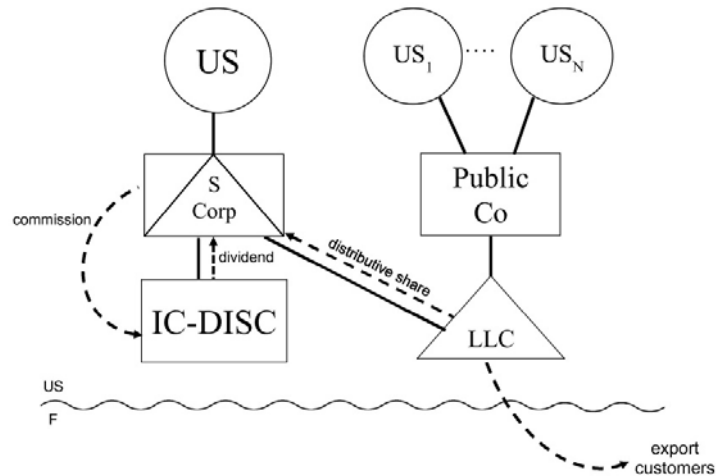
- (a) The beneficiaries of the trust would be the owners of the C corporation's shares.
 - (b) This structure would avoid changing the ownership percentage of the IC-DISC shares every time ownership of the C corporation's shares change.
5. LLC ownership also works but is not as easy to draft.



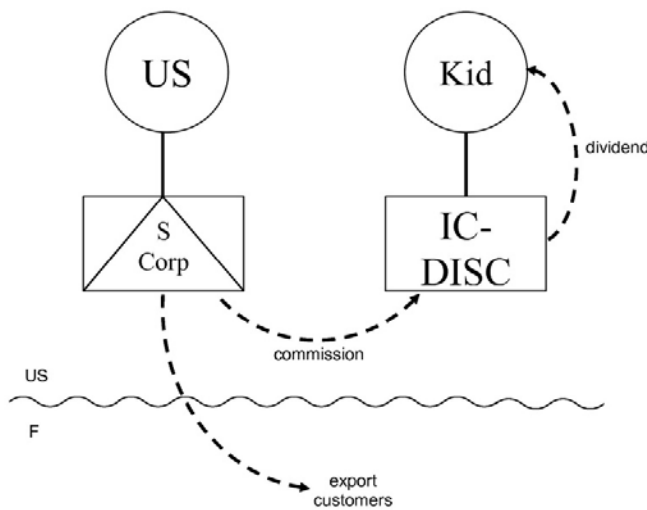
6. An exporter can use multiple C corporations, without electing consolidated return status, to take advantage of lower marginal rates in each of multiple C corporations that own the IC-DISC.



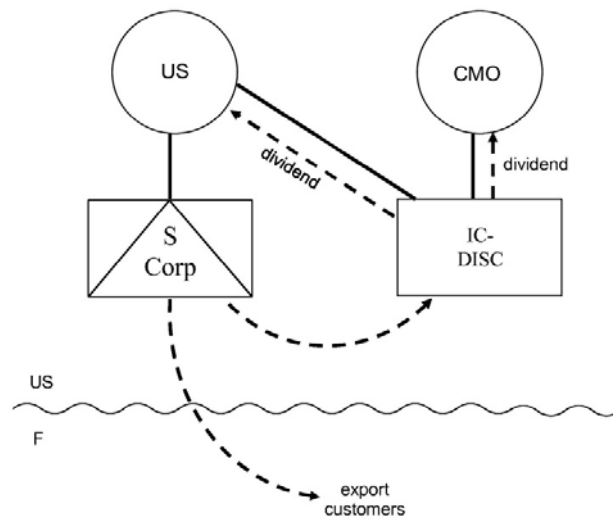
7. An S corporation (or another flow-through entity, such as an LLC), can use an IC-DISC when entering a joint venture with a public company.



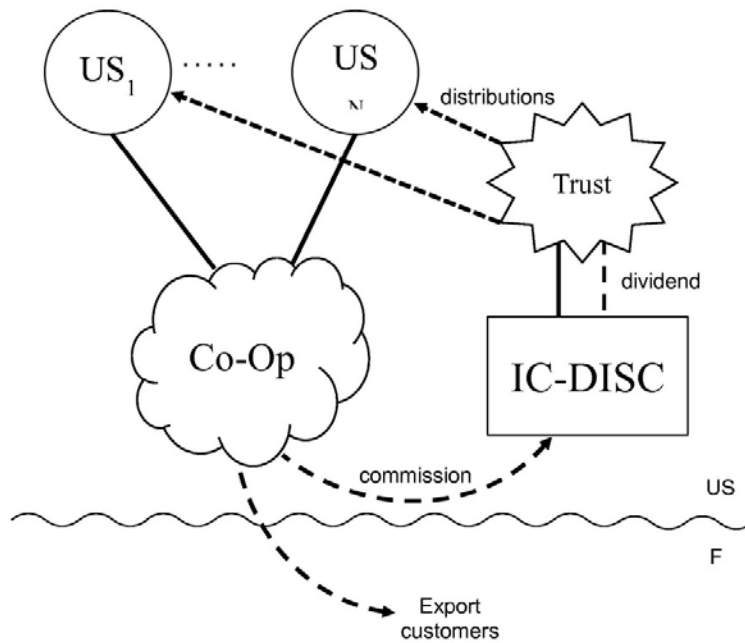
- C. Provision of IC-DISC shares to someone who is not currently an owner of the exporter.
 1. Does providing IC-DISC shares to a family member result in gift tax implications?



2. IC-DISC shares could be provided to an employee who is not an owner of the exporter.

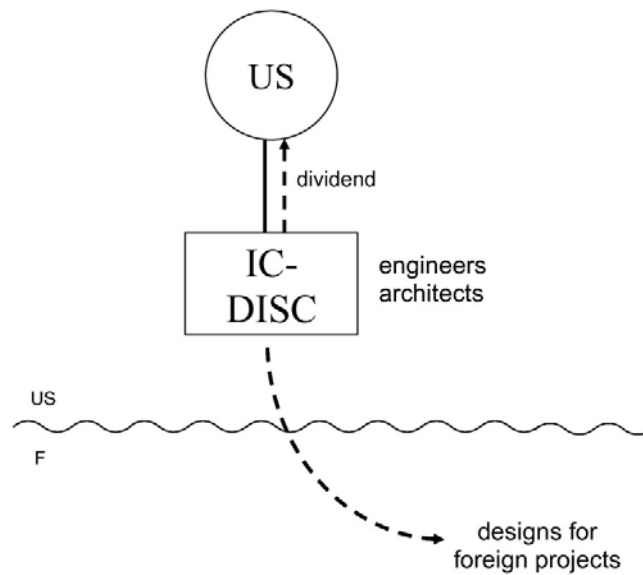


- D. IC-DISCs can turn patronage dividends (taxed at ordinary rates) into qualified dividends.

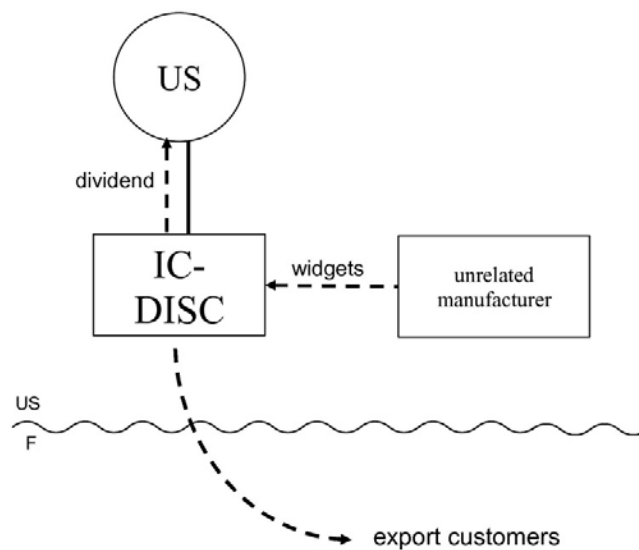


E. Use of only an IC-DISC without another entity.

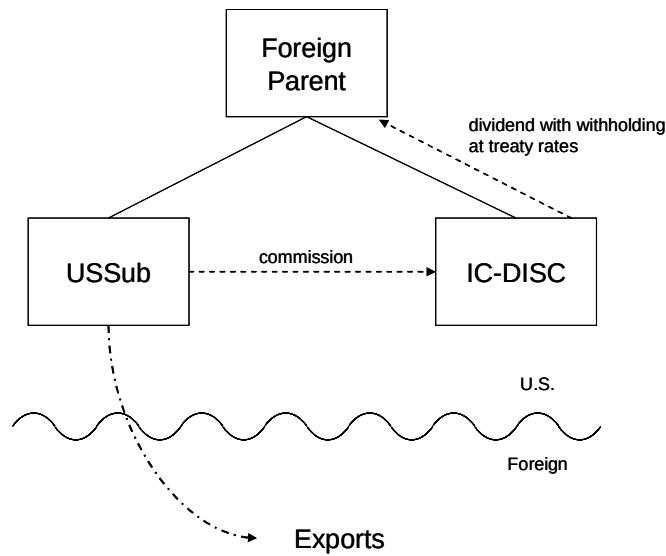
1. Architects and engineers providing designs for foreign projects can all be in one IC-DISC.



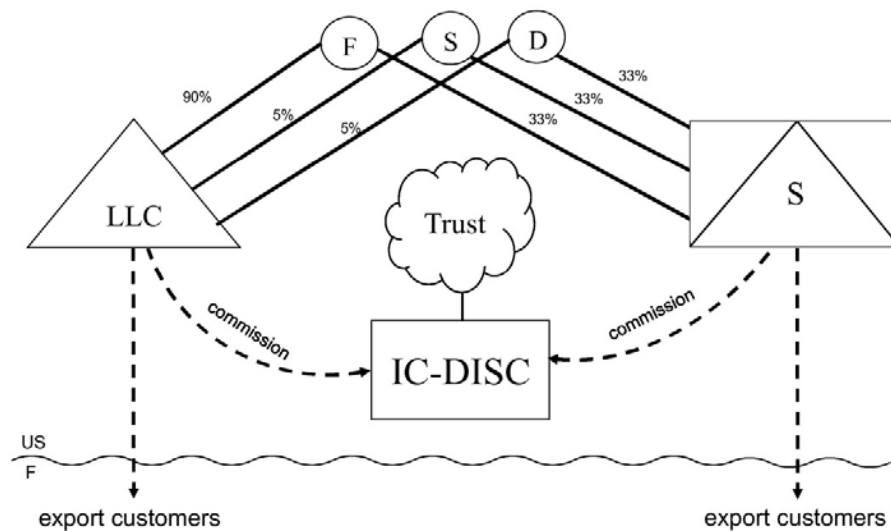
2. Because an IC-DISC cannot manufacture product, a pure distributor that merely exports can capture the entire benefit of an IC-DISC.



- F. A foreign parent in a country with a recently ratified treaty with the United States can take advantage of reduced treaty rates.

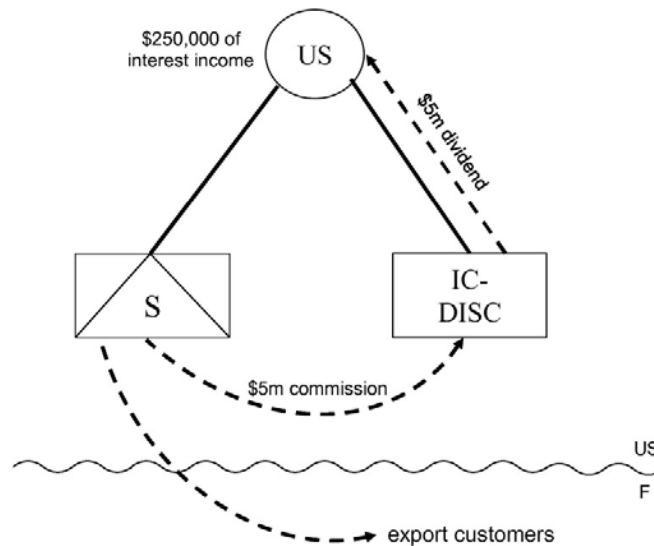


- G. An IC-DISC can be used with a trust to capture the benefits of two related exporting entities that have varying ownership interests.

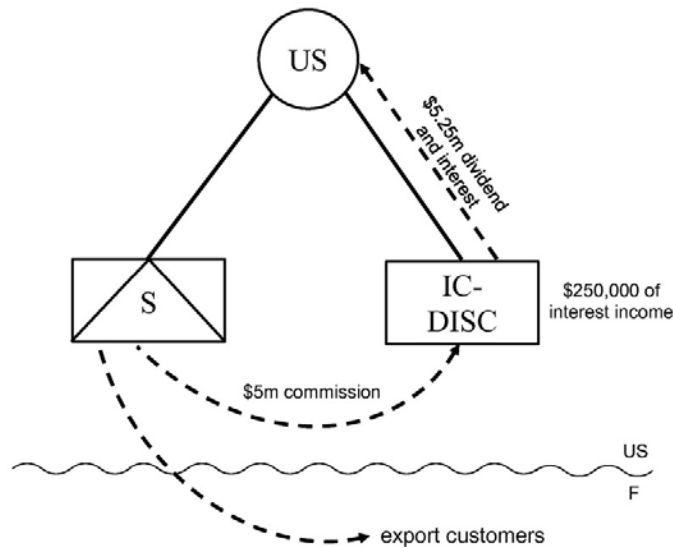


H. Can move some, but only 5% of the receipts constituting non-qualified export receipts to take advantage of tax savings.

1. If U.S. individual receives \$250,000 of interest income, it is taxed at marginal rates.

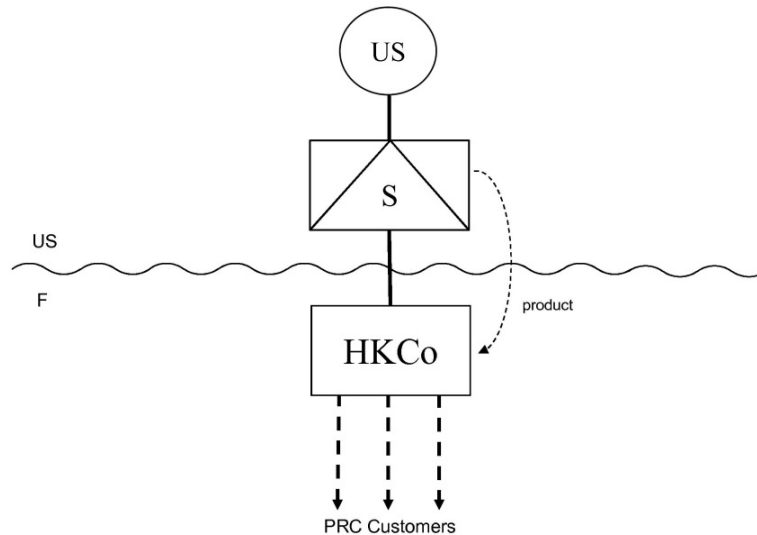


2. As long as \$250,000 of interest income is less than 5% of all IC-DISC receipts, the interest income can be taxed at qualified dividend rates.

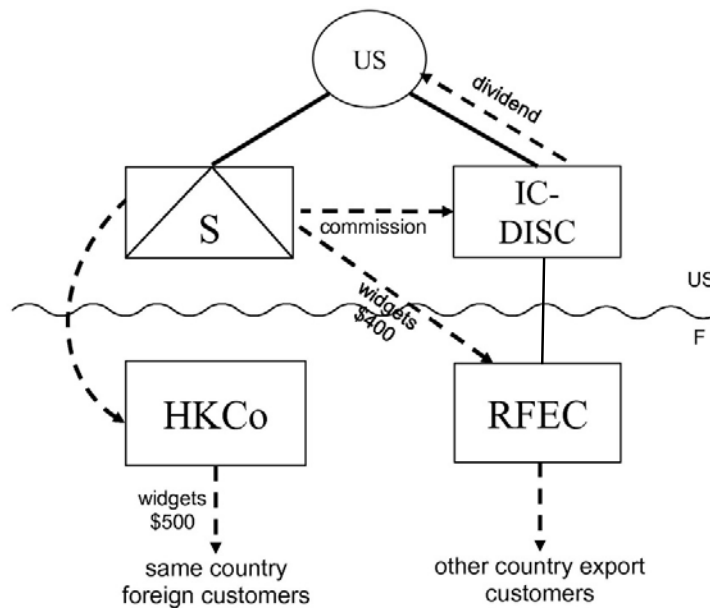


I. IC-DISC to avoid Subpart F.

1. Foreign based company sales income occurs when product manufactured outside the CFC's country of incorporation and sold for use outside the CFC's country of incorporation as a related-party component.



2. We can convert ordinary income inclusions from Subpart F into qualified dividend income via a Related Foreign Export Corporation.



VII. IMPLEMENTATION CONSIDERATIONS FOR THE IC-DISC

- A. Execution is critical to ensure that the IC-DISC and the export sales qualify for this benefit.
- B. Implementation considerations include the following:
 - 1. Incorporate the IC-DISC before the export sales begin and make a \$3,000 capital contribution;
 - 2. Analyze the export sales, which includes sales to Canada;
 - 3. Draft the commission agreement between the IC-DISC and the exporter;
 - 4. Prepare and file the Form 4876-A that elects IC-DISC status for the corporation;
 - 5. Prepare a manual that contains guidelines for the client's operating procedures, which includes a checklist/calendar to determine when the client should complete various activities, such as when the client should determine that the IC-DISC has satisfied the gross receipts test and the export assets test.

¹ Code Sec. 992(a)(1)(C).

² Code Sec. 992(a)(1)(C).

³ Reg. § 1.992-2.

⁴ Code Sec. 991.

⁵ The 35% individual tax rate less the 15% qualified dividend rate is twenty percentage points.

⁶ After a corporate tax rate of 35%, the qualified dividend rate of 20% results in an effective rate of 48%, which is 28 percentage points higher than the 20% dividend rate.

⁷ Code Sec. 995(a) and (b).

⁸ Code Sec. 995(b)(1)(E). It is not possible to circumvent the \$10 million limitation by creating multiple IC-DISCs. Code Sec. 995(b)(4)(B).

⁹ Code Sec. 995(f)(2). A U.S. shareholder must continue to pay interest on deferred IC-DISC income until that income is distributed or deemed distributed by the IC-DISC. The interest rate is the current market rate for 52-week Treasury bills. Code Sec. 995(f)(4).

¹⁰ Code Sec. 1411.

¹¹ Code Secs. 992(a)(1) and 993(d) and (f).

¹² Code Secs. 992(a)(1)(E) and 993(b).

¹³ Code Sec. 993(b)(4).

¹⁴ Code Sec. 993(c).

¹⁵ Reg. § 1.993-3(c).

¹⁶ 245 F.3d 149 (2d Cir. 2001); *rev'g* 70 TCM 39 (1995).

¹⁷ Code Sec. 993(c)(1)(B).

¹⁸ Reg. § 1.993-3(d)(2)(i)(a).

¹⁹ Reg. § 1.993-3(d)(2)(i)(b).

²⁰ Reg. § 1.993-3(e)(4)(i).

²¹ Code Sec. 994(a)(1).

²² Code Sec. 994(a)(2).

²³ Code Sec. 994(a)(3).

²⁴ The IC-DISC may also add 10% of its export promotion expenses to the commission, but the export promotion expenses are typically negligible.

²⁵ Reg. § 1.994-1(c)(7).

²⁶ Reg. § 1.994-1(e)(1).

²⁷ Reg. § 1.994-1(c)(7)(ii).

²⁸ Reg. § 1.994-1(c)(7)(iii).

²⁹ Code Sec. 994(b)(2) and Reg. § 1.994-2(c).

³⁰ Reg. § 1.994-1(c)(3).

³¹ Reg. § 1.994-2(b)(2).

³² Reg. § 1.994-2(b)(1). When computing marginal costing combined taxable income, taxpayers use the same transaction grouping procedures available when computing full costing combined taxable income.

³³ Reg. § 1.994-2(b)(3).

³⁴ Reg. § 1.994-1(c)(6)(iii).

³⁵ For an example in the context of research and development expenditures, see *St. Jude Medical, Inc. v. Comm'r*, 34 F.3d 1394 (8th Cir. 1994).

³⁶ Code Sec. 243(a). The dividends are not coming from an entity subject to corporate tax.

Robert Misey is a partner with the U.S. law firm of Reinhart Boerner Van Deuren s.c. and Chair of that firm's International Department. Mr. Misey concentrates his practice in the areas of international taxation and business. Mr. Misey's previous experience includes nine years as an attorney for the IRS. While he was with the IRS, he served as an international tax attorney in its Washington, D.C. national office, where he was a member of the APA team, and a trial attorney and international tax specialist in San Jose, California and the Southeast Region. He previously led the International Tax Services group for a region of a Big Four accounting firm.

Mr. Misey has spoken on international taxation at continuing education programs in many states and foreign countries. He has published numerous articles and has authored the treatises *U.S. Taxation of International Transactions*, *ETI Repeal Under The American Jobs Creation Act of 2004* and *Federal Taxation: Practice and Procedure*.

Mr. Misey received his Juris Doctor and Master of Business Administration degrees from Vanderbilt University and his Master of Laws in Taxation, with high distinction, from Georgetown University, where he was the graduate student editor of *The Tax Lawyer*. A member of the bar in California, Kentucky, Wisconsin and the District of Columbia, he can be reached via phone at either 312-207-5466 or 414-298-8135 or via e-mail at rmisey@reinhartlaw.com.

IC-DISCs: Structuring to Maximize Tax Benefits

Presented by

Robert Misey, Esq.

Chair, International Department
Reinhart Boerner Van Deuren, s.c.

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Today's Discussion Topics

- Tax benefits of the IC-DISC
- Tests to qualify as an IC-DISC
- Requirements—manufacturing, destination, content
- Determining and maximizing the IC-DISC benefit
- A multitude of structuring techniques, including
 - The use of trusts for exporters whose ownership percentage changes
 - The use of IC-DISCs to compensate certain employees

Introduction to IC-DISC

- Formation of the IC-DISC
 - A single class of stock
 - A minimum par value of \$2,500
 - Elect to be an IC-DISC with a Form 4876-A

Introduction to IC-DISC (cont.)

- Taxation of an IC-DISC and its shareholders
 - An IC-DISC is not subject to corporate tax
 - When the IC-DISC pays a dividend, its owners will pay tax at a 20% rate
 - If the manufacturing entity is a flow-through entity, the tax savings are 20 percentage points
 - If the manufacturing entity is a C corporation, the tax savings are 28 percentage points

The Tests to Qualify as an IC-DISC

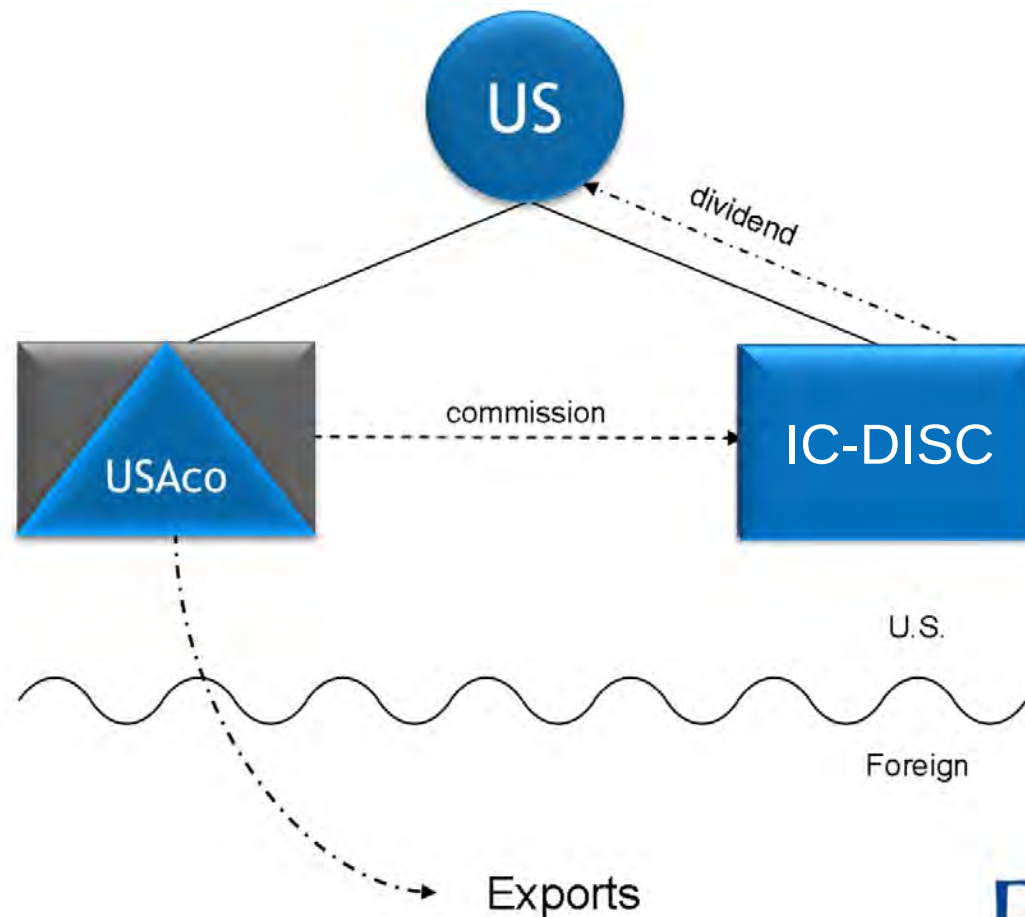
- Qualified Export Receipts Test
- Qualified Export Assets Test

The Tests to Qualify as an IC-DISC (cont.)

- 95% of its gross receipts must constitute qualified export receipts
 - Sales of export property
 - Rents for use of export property outside the United States
 - Services related to exports
 - Engineering or architectural services for construction projects abroad, and
 - Commissions

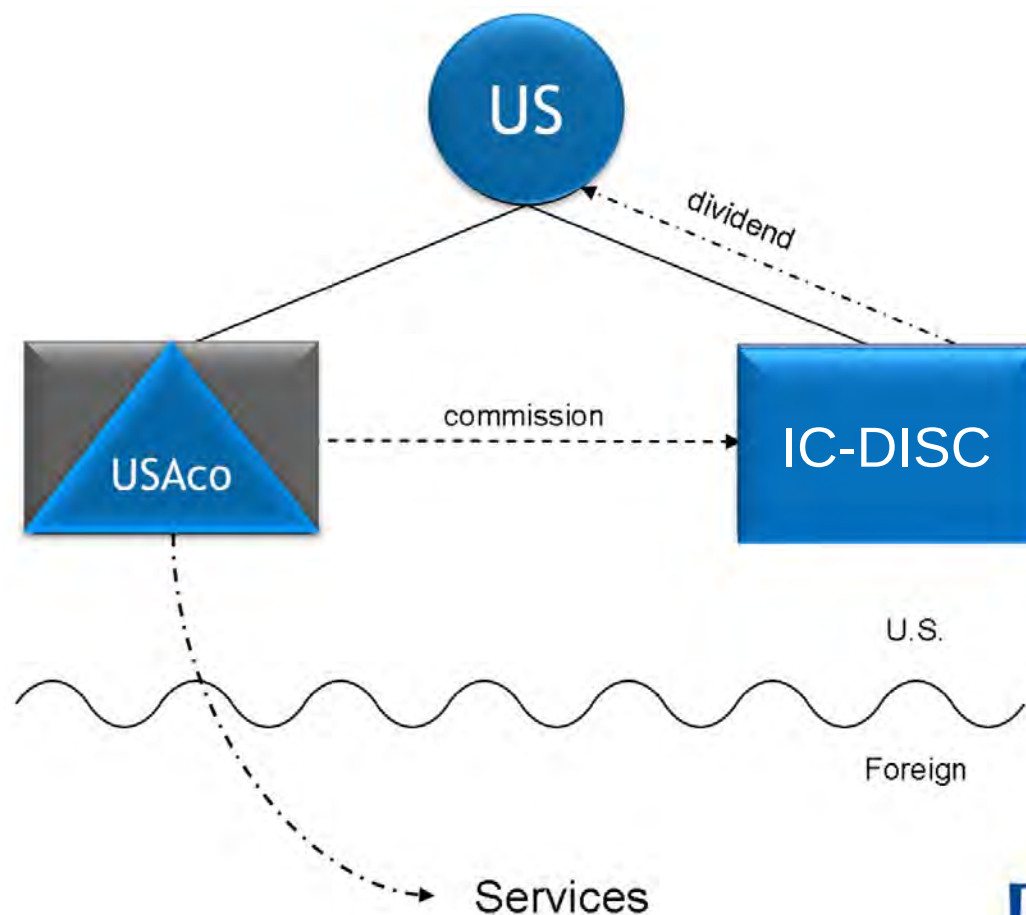
Example 1

Sales Produce Gross Receipts



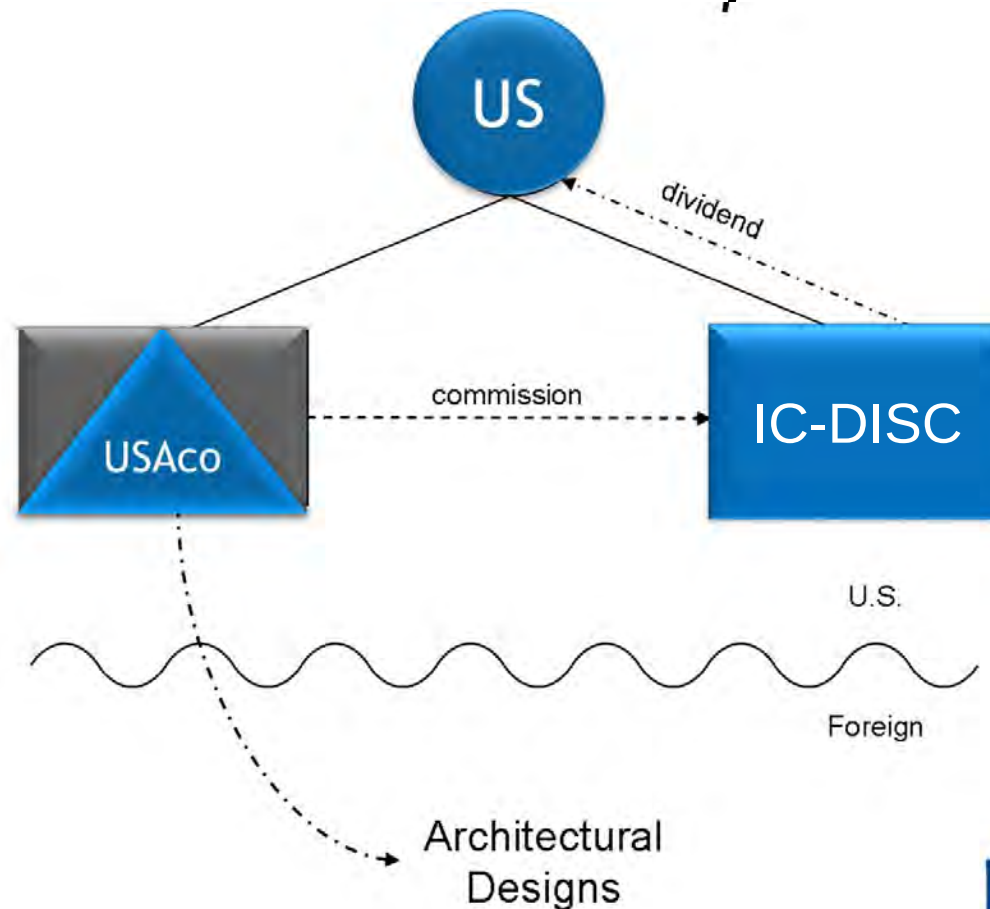
Example 2

Services Produce Gross Receipts



Example 3

Architectural Services Produce Gross Receipts

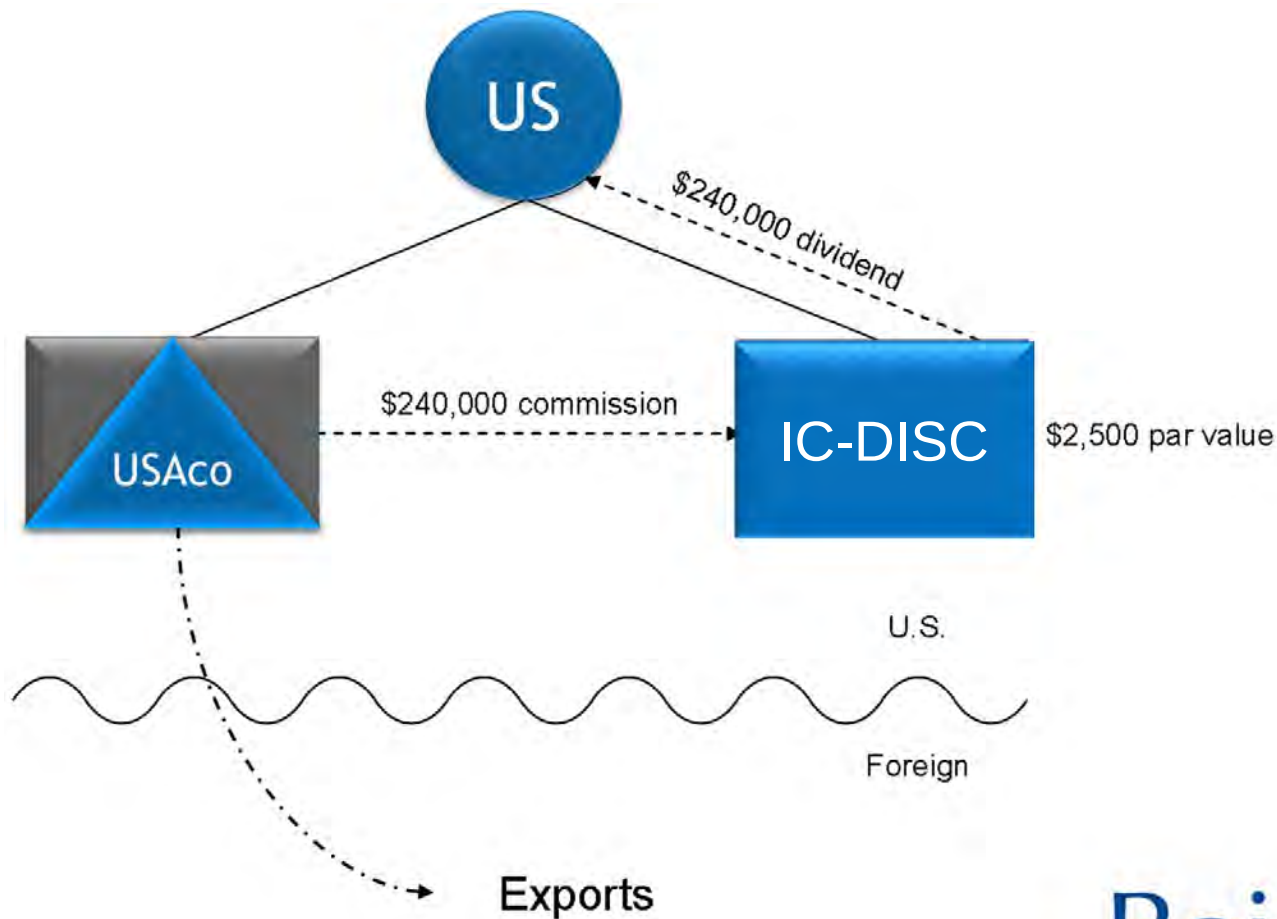


The Tests to Qualify as an IC-DISC

- 95% of the assets of the IC-DISC must be qualified export assets
 - Temporary investments
 - Export property
 - Accounts receivable
 - Loans to producers

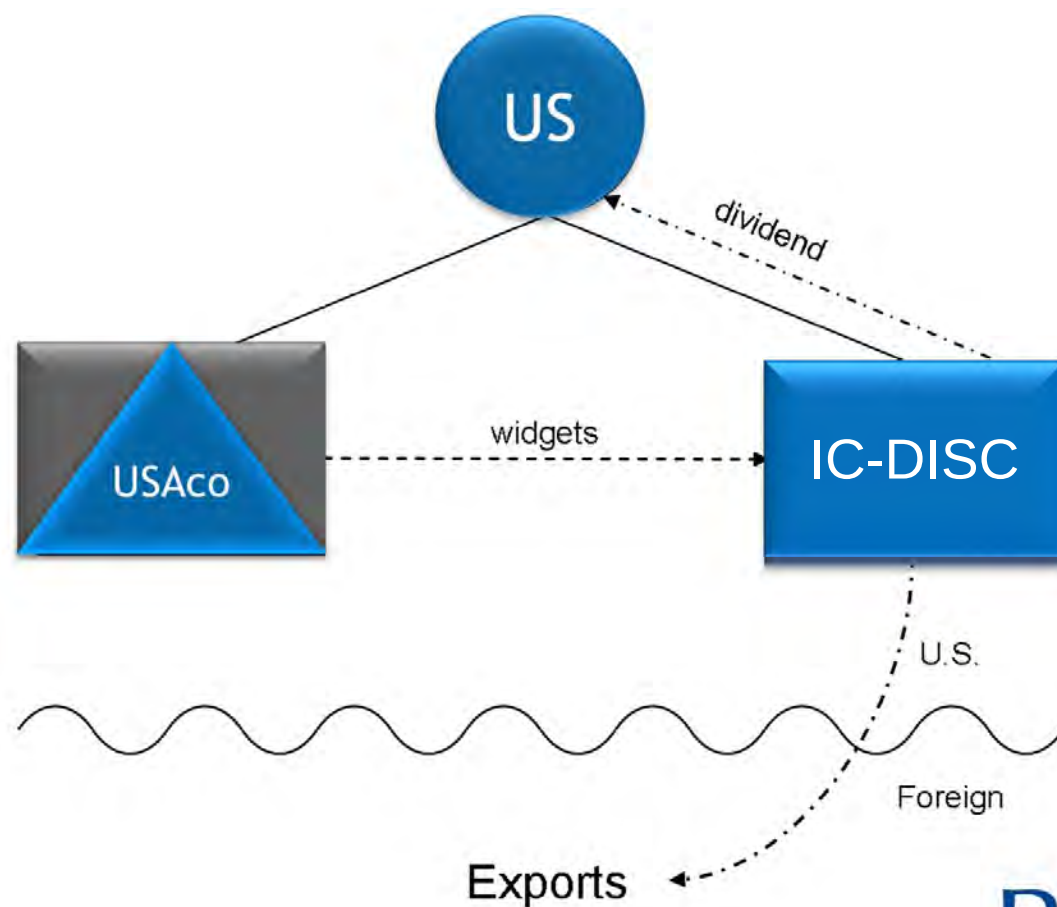
Example 4

Working Capital as Qualified Export Assets



Example 5

Export Property as Qualified Export Assets



Qualification as Export Property

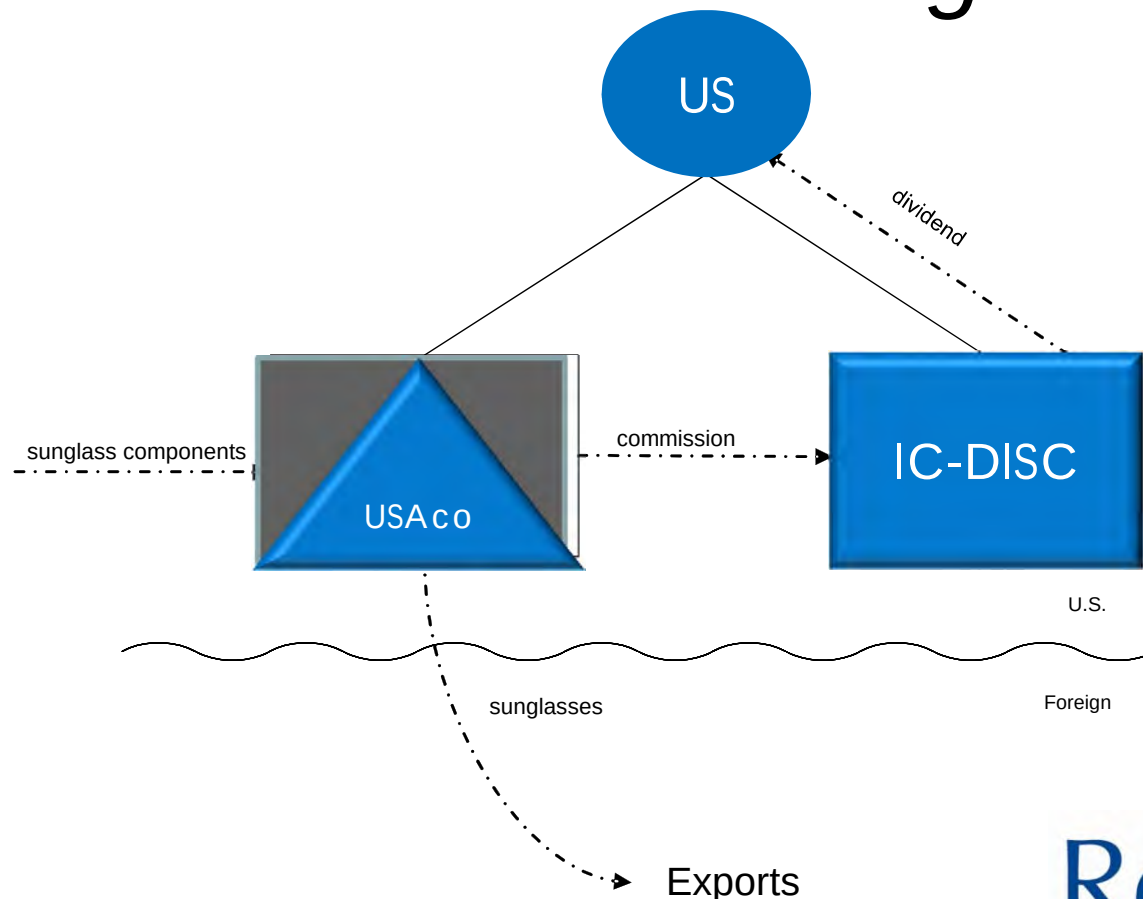
- The property must be manufactured in the U.S. by a person other than the IC-DISC
- The export property must be held primarily for use outside the U.S.
- The property must have a maximum of 50% foreign content

Qualification as Export Property (cont.)

- Property is manufactured within the U.S. if either
 - U.S. conversion costs incurred constitute 20% of the cost of goods sold
 - There is a substantial transformation in the United States, or
 - The operations in the U.S. are generally considered to constitute manufacturing

Example 6

Generally Considered to Constitute Manufacturing



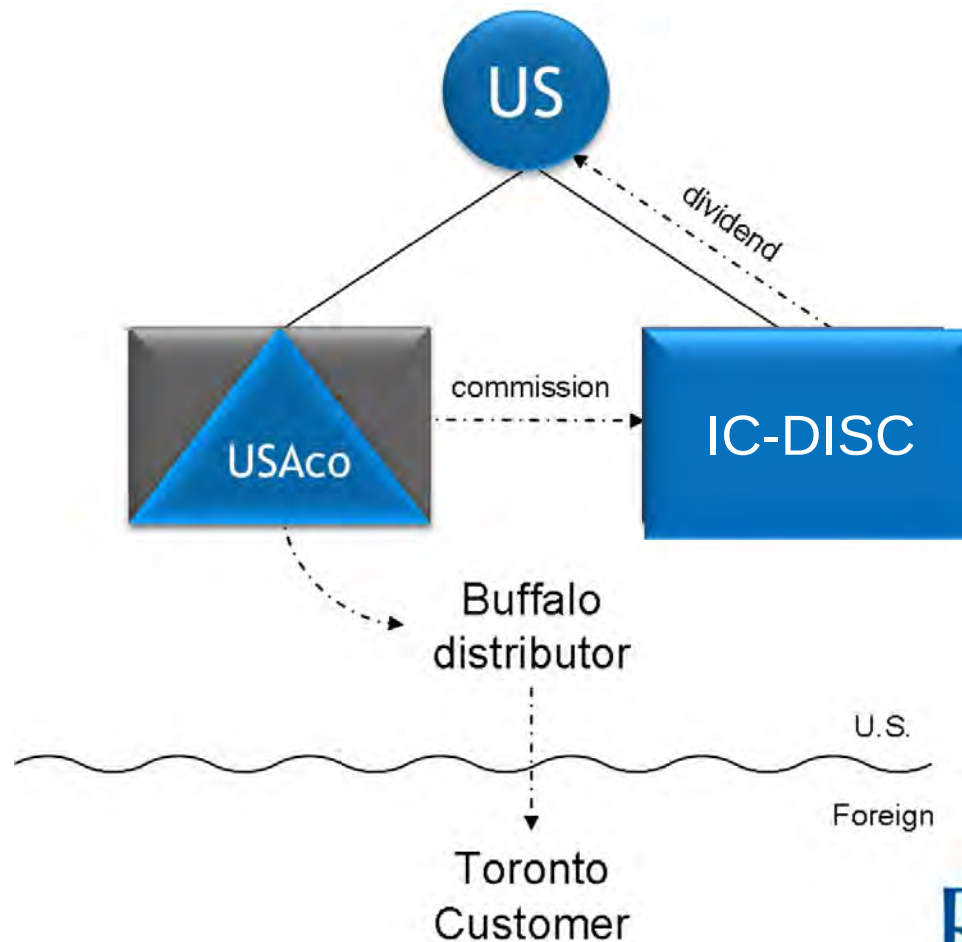
Qualification as Export Property

- The Destination Requirement
 - The destination test requires being held for use outside the United States



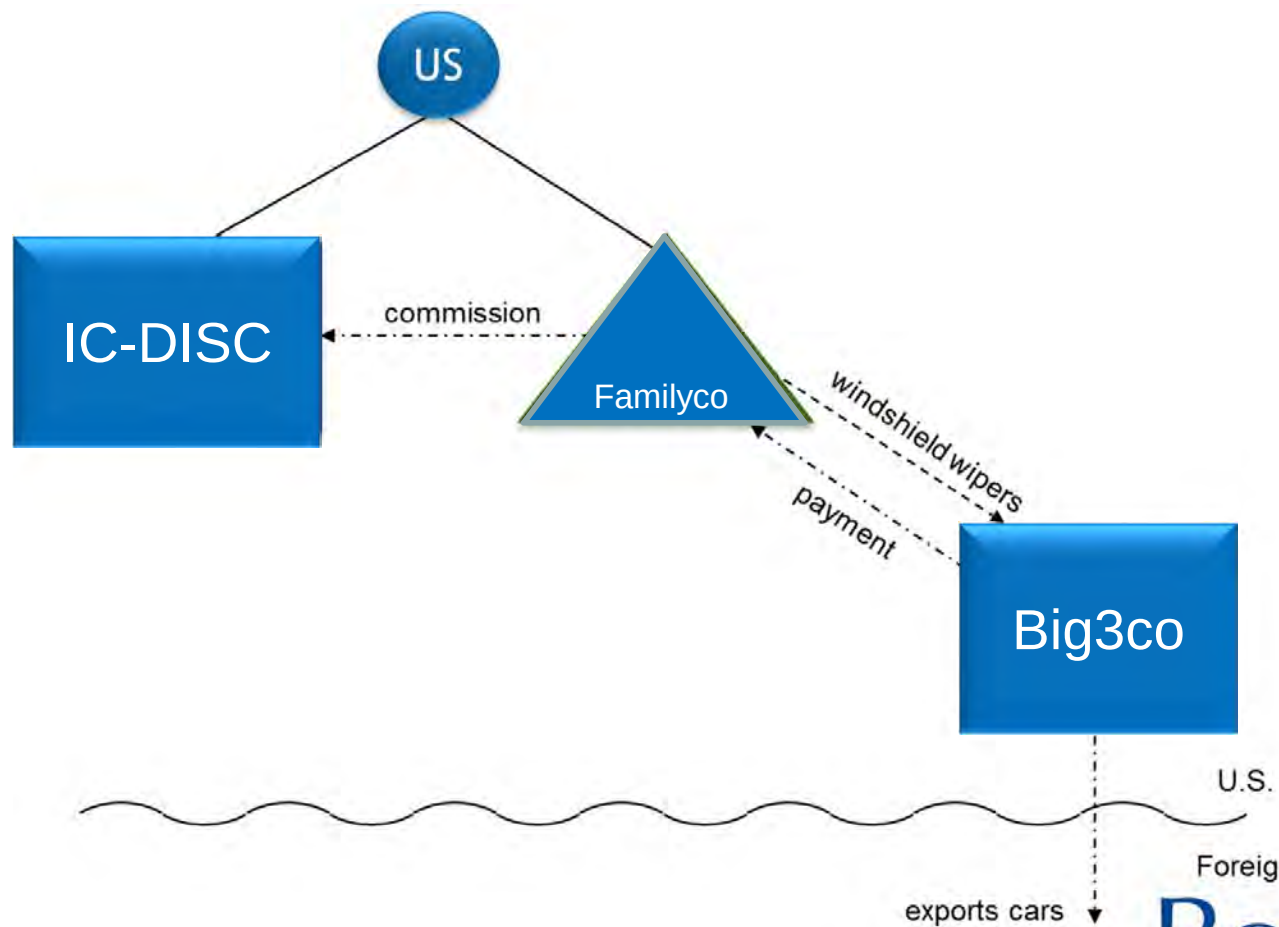
Example 7

Satisfying the Destination Test

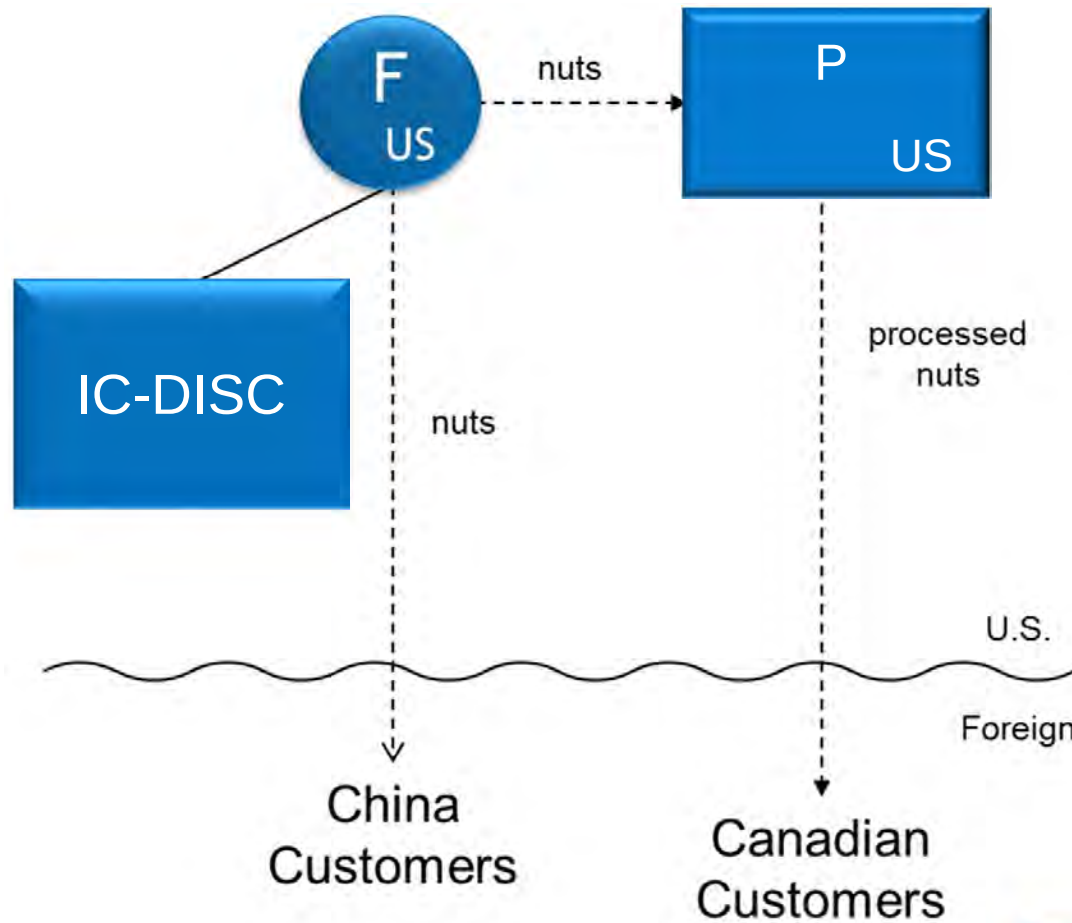


Example 8

No Further U.S. Manufacturing



Example 9



Qualification as Export Property (cont.)

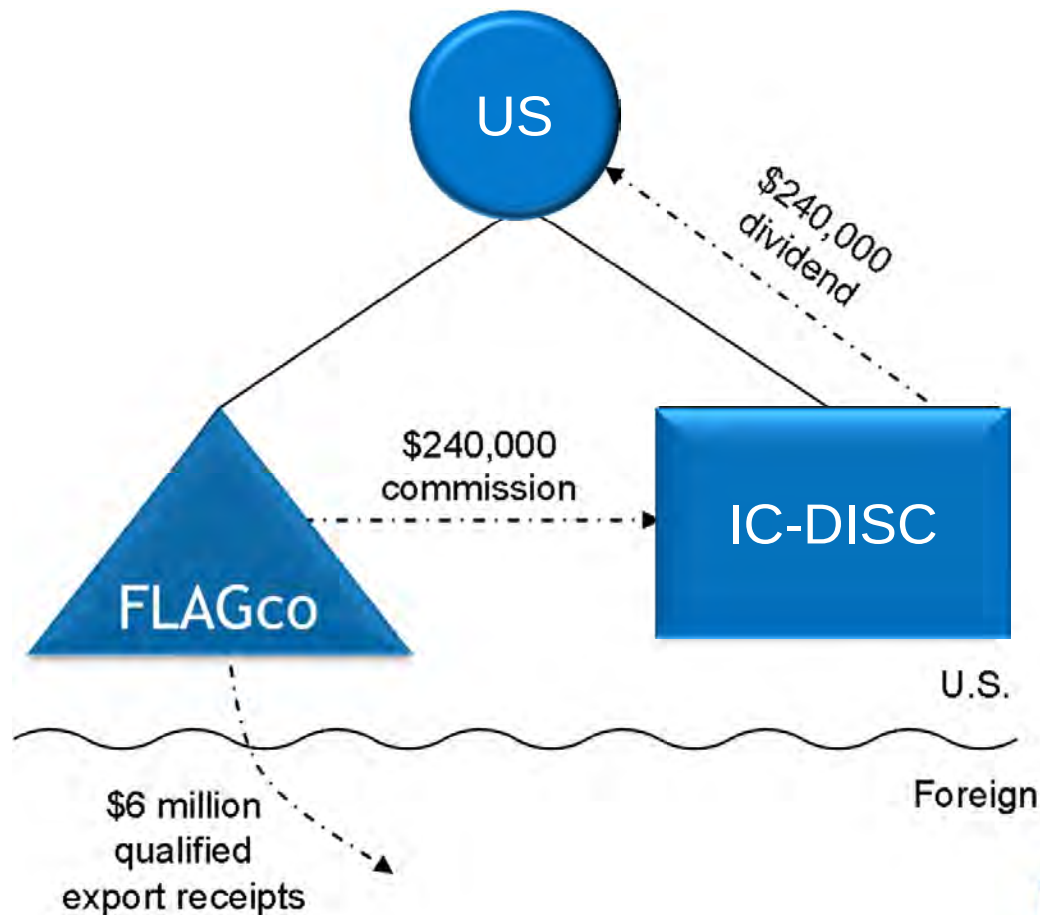
- The Maximum of 50% Foreign Content Requirement
 - No more than 50% of the fair market value of export property may be attributable to the fair market value of imported articles
 - The fair market value of the foreign content is determined by its dutiable value

Determining the IC-DISC Benefit

- The commission is the greater of
 - 4% of the qualified export receipts
 - 50% of the combined taxable income, or
 - The arm's-length amount determined under the transfer pricing principles of Section 482

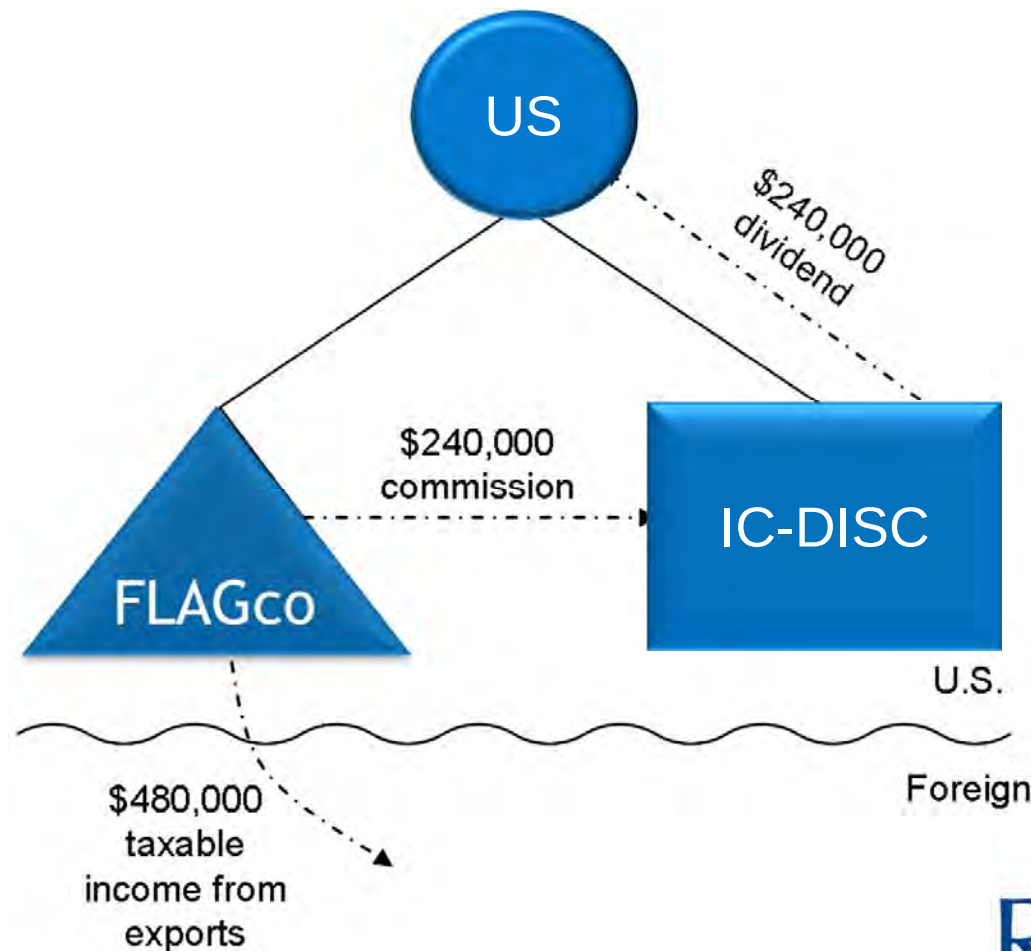
Example 10

4% of the Qualified Export Receipts



Example 11

50% of Combined Taxable Income



Maximizing the IC-DISC's Income

- Grouping
- Marginal Costing
- Expense Allocations

Maximizing the IC-DISC's Income (cont.)

- The combined taxable income method when exports have a net pre-tax margin of 8% or greater
- The qualified export receipts method when exports have a net pre-tax margin of less than 8%

Maximizing the IC-DISC's Income (cont.)

- Grouping
 - Maximizing the commission by separating the high-margin sales from the low-margin sales

Example 12

Grouping to Maximize Commissions

- VinCo, a domestic S corporation, exports domestically produced beer and wine

	<i>Gross receipts</i>	<i>Combined taxable income</i>	<i>Net pre-tax margin</i>	<i>Grouped Commission</i>
Beer	\$ 5,000,000	\$1,000,000	20%	\$500,000
Wine	<u>\$ 5,000,000</u>	<u>\$ 200,000</u>	4%	<u>\$200,000</u>
Total export sales	<u>\$10,000,000</u>	<u>\$1,200,000</u>	12%	<u>\$700,000</u>

Maximizing the IC-DISC's Income (cont.)

- Marginal Costing
 - Only marginal costs (*e.g.*, direct costs) are considered when computing combined taxable income

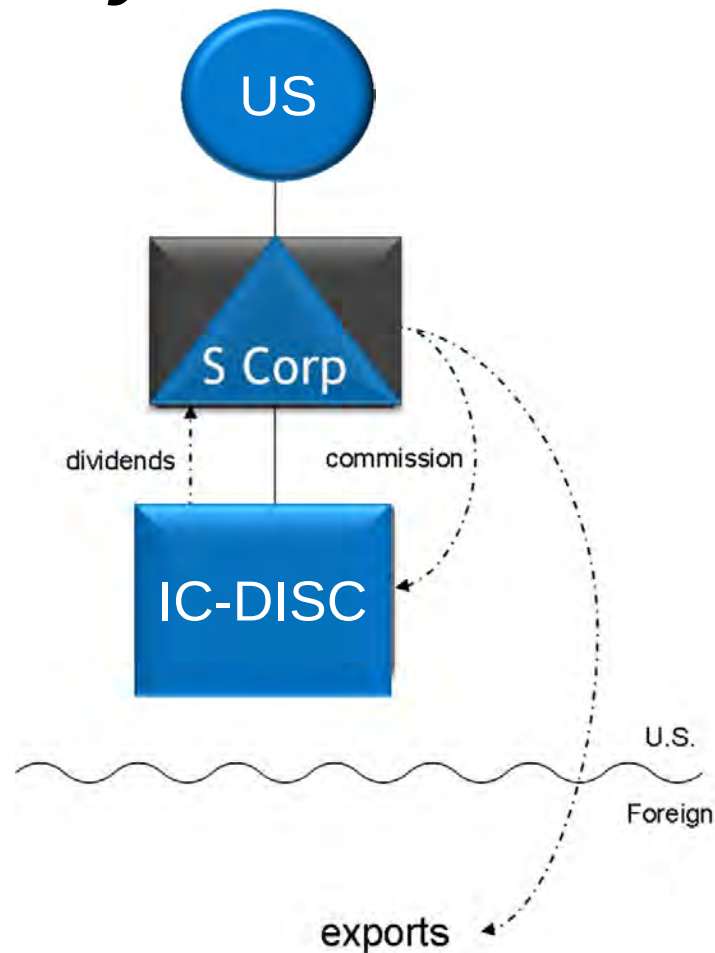
Maximizing the IC-DISC's Income (cont.)

- Marginal Costing
 - An overall profit percentage limitation restricts the combined taxable income to an amount equal to qualified export receipts multiplied by the ratio of full costing combined taxable income from all sales to total receipts from all sales

Maximizing the IC-DISC's Income (cont.)

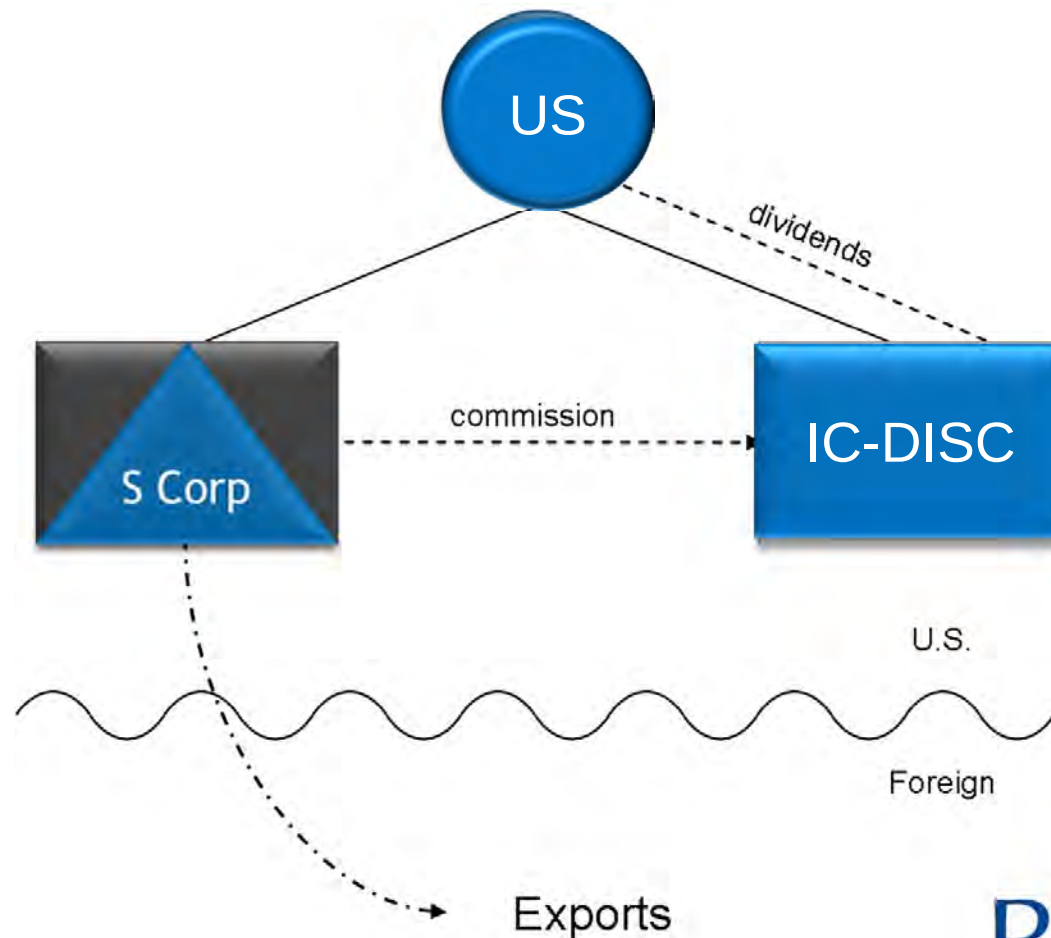
- Expense Allocations
 - A taxpayer can increase combined taxable income by allocating fewer deductions against qualified export receipts

Structuring the IC-DISC *Subsidiary of a Flow-Through*

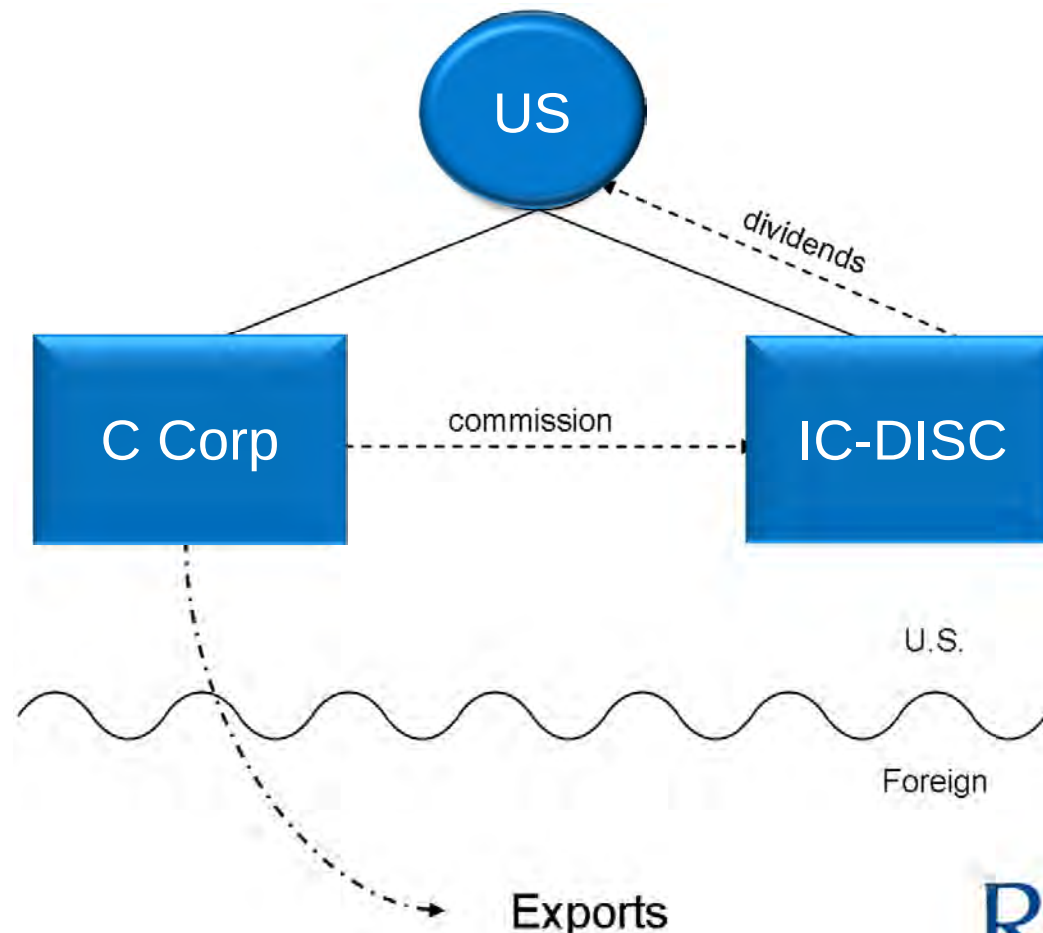


Structuring the IC-DISC

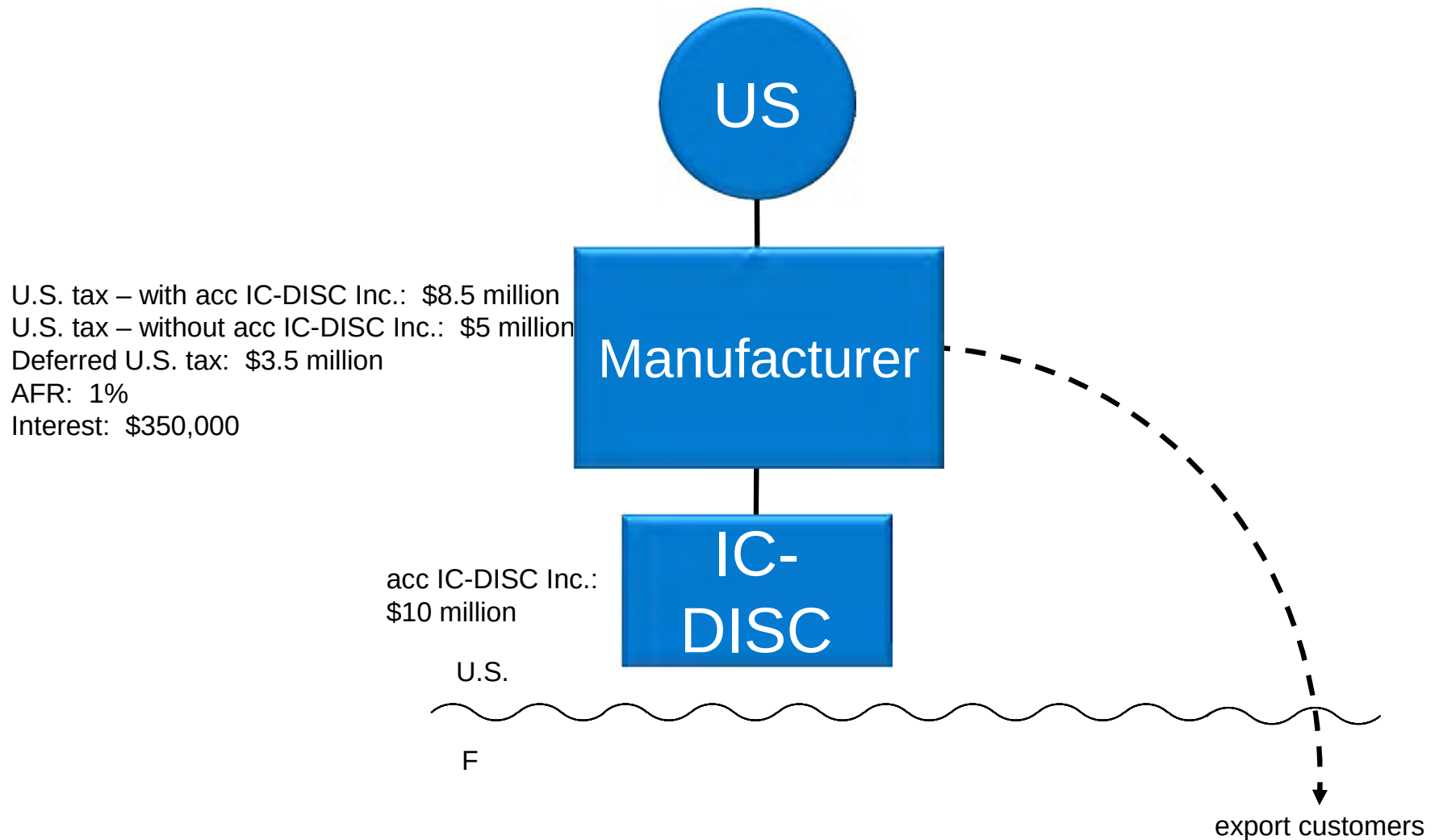
Brother-Sister of a Flow-Through



Structuring the IC-DISC *Brother-Sister of a C Corporation*

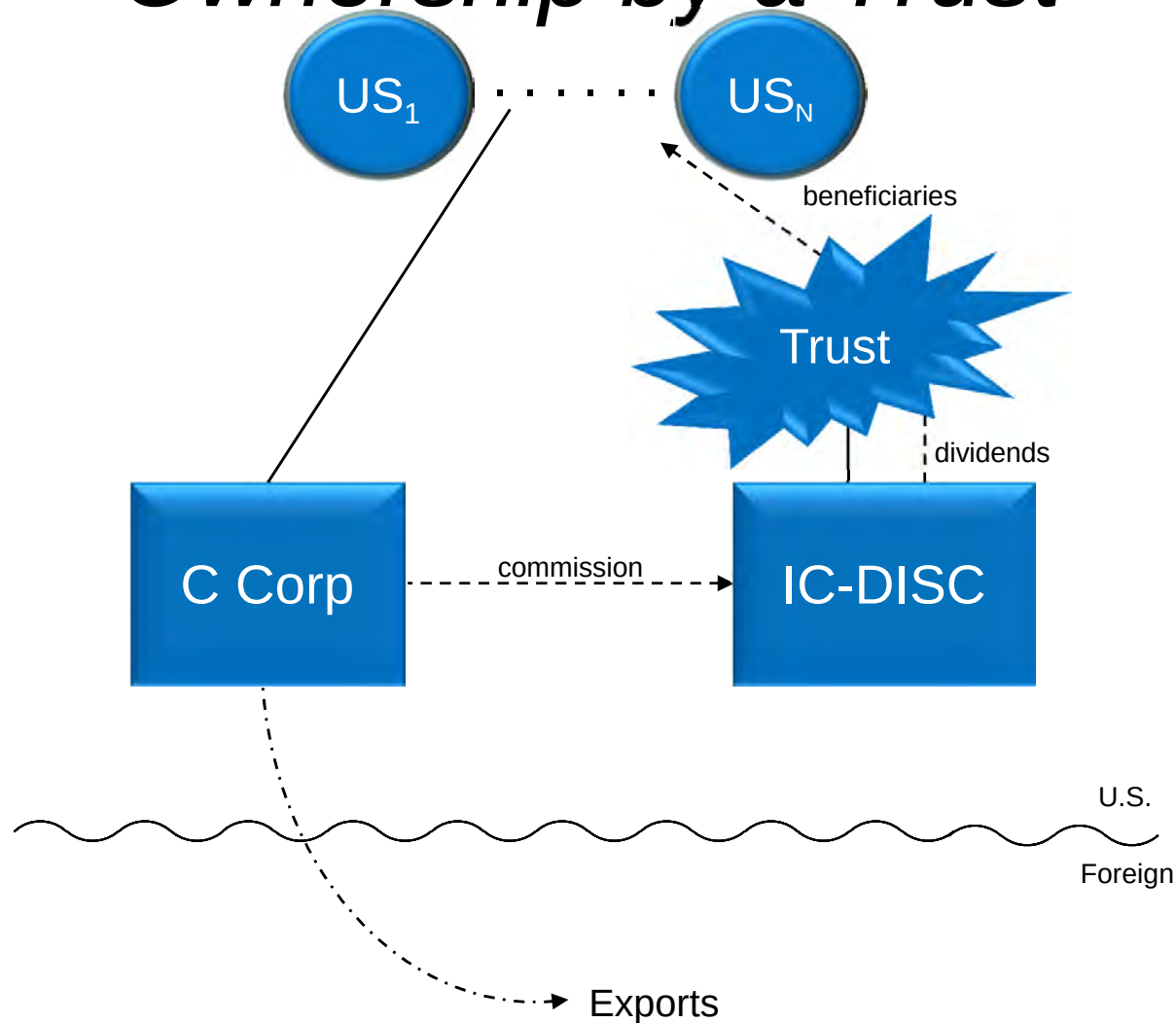


The Interest Charge in IC-DISC



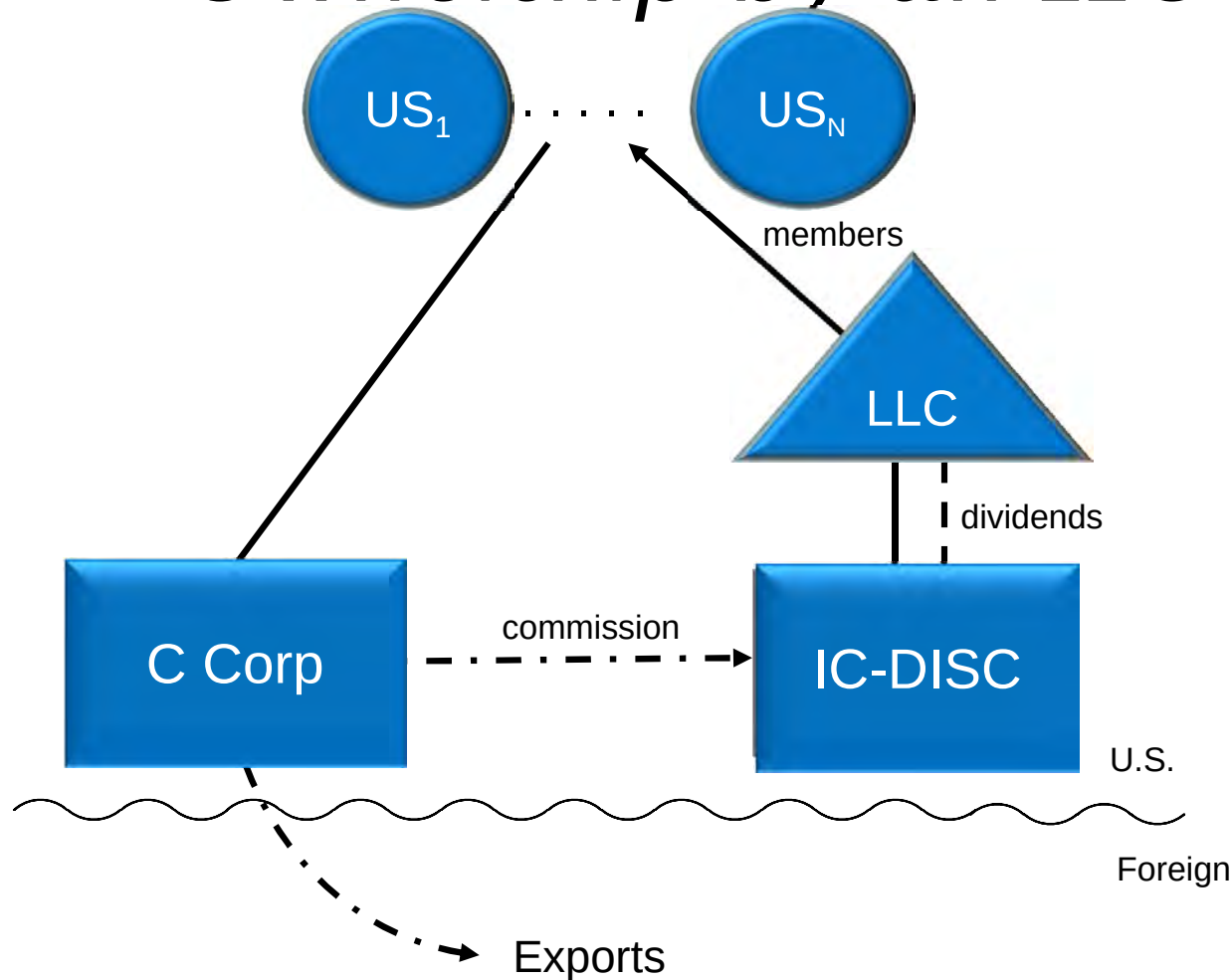
Structuring the IC-DISC

Ownership by a Trust

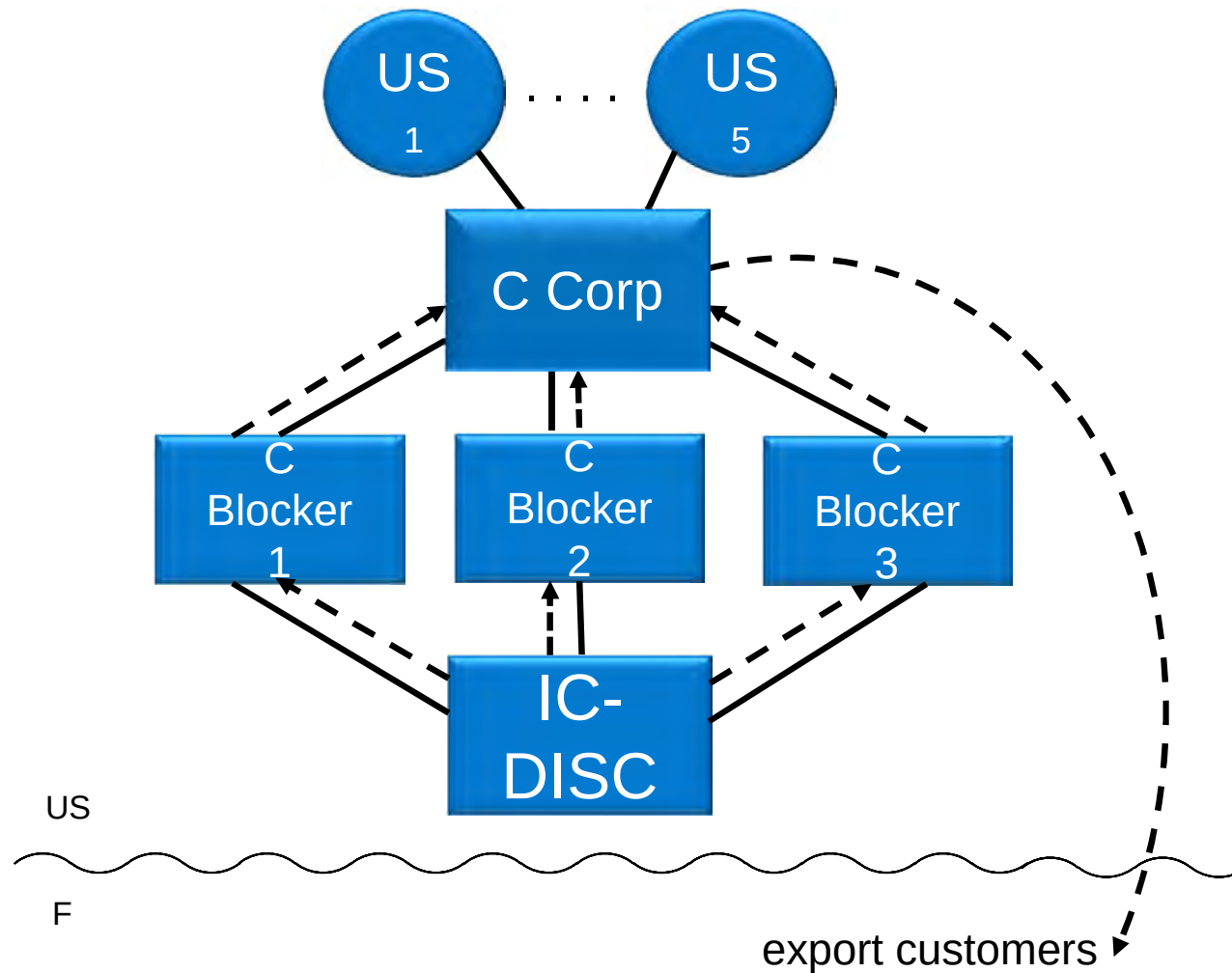


Structuring the IC-DISC

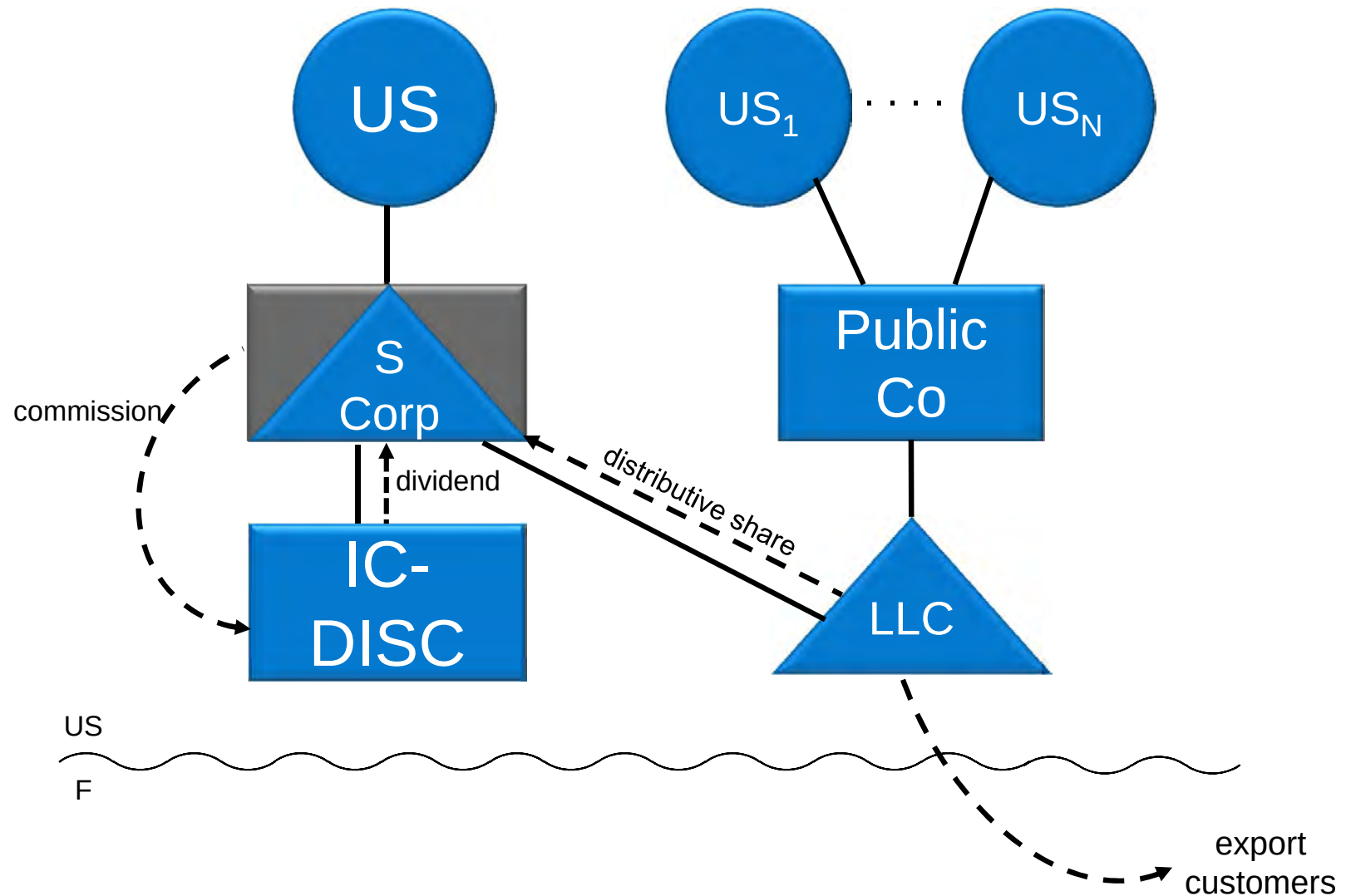
Ownership by an LLC



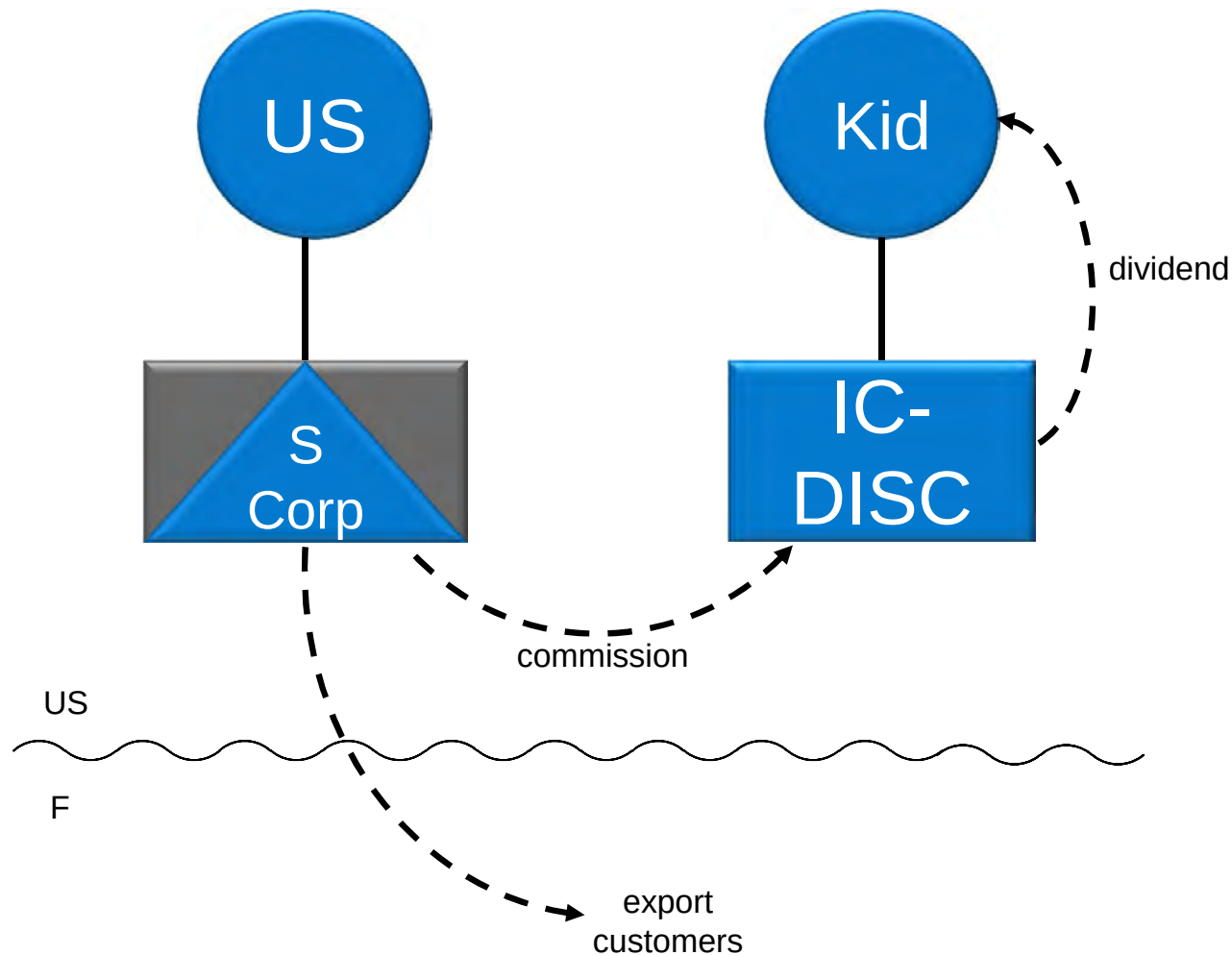
Multiple C Corporations



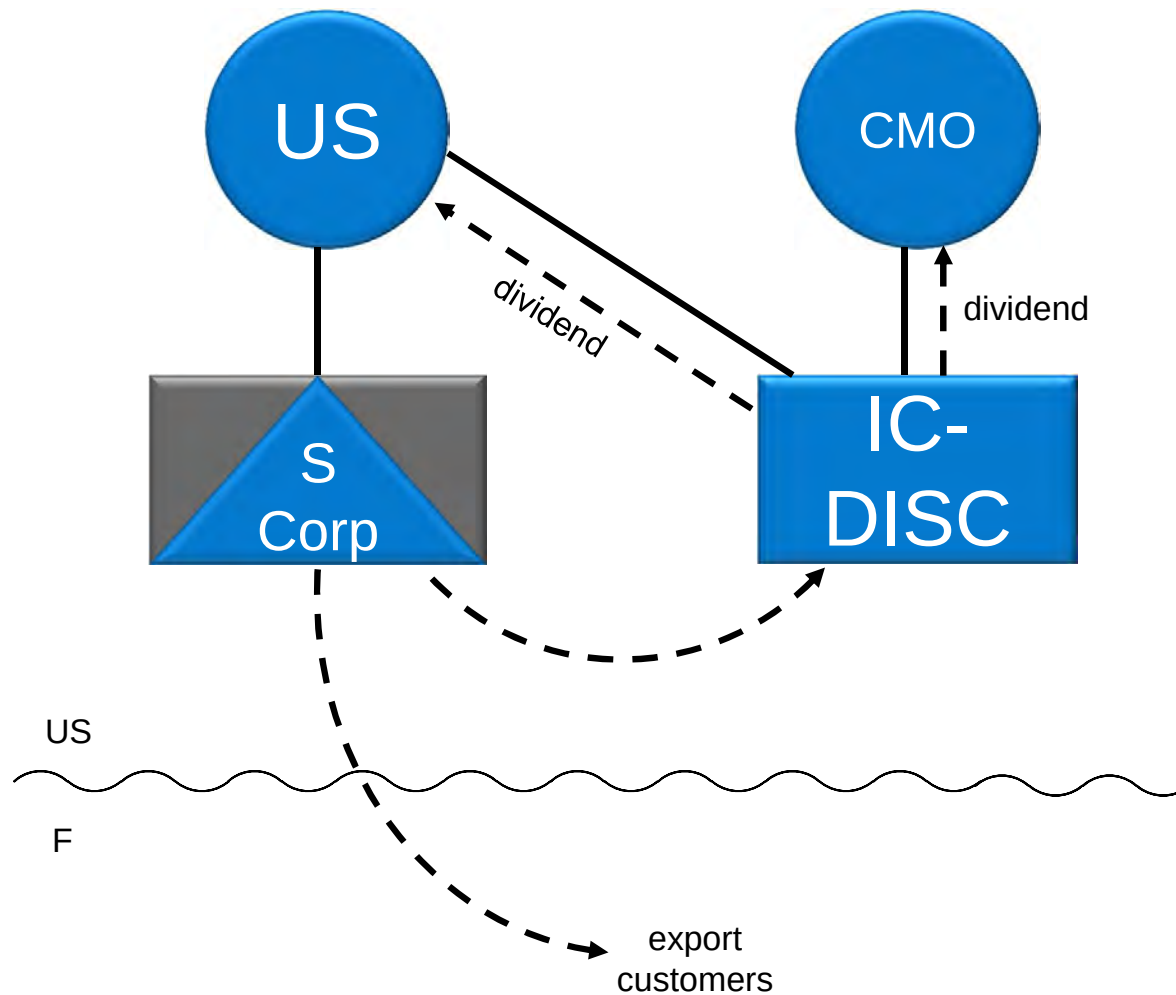
Joint Venture: S Corp and Public Co



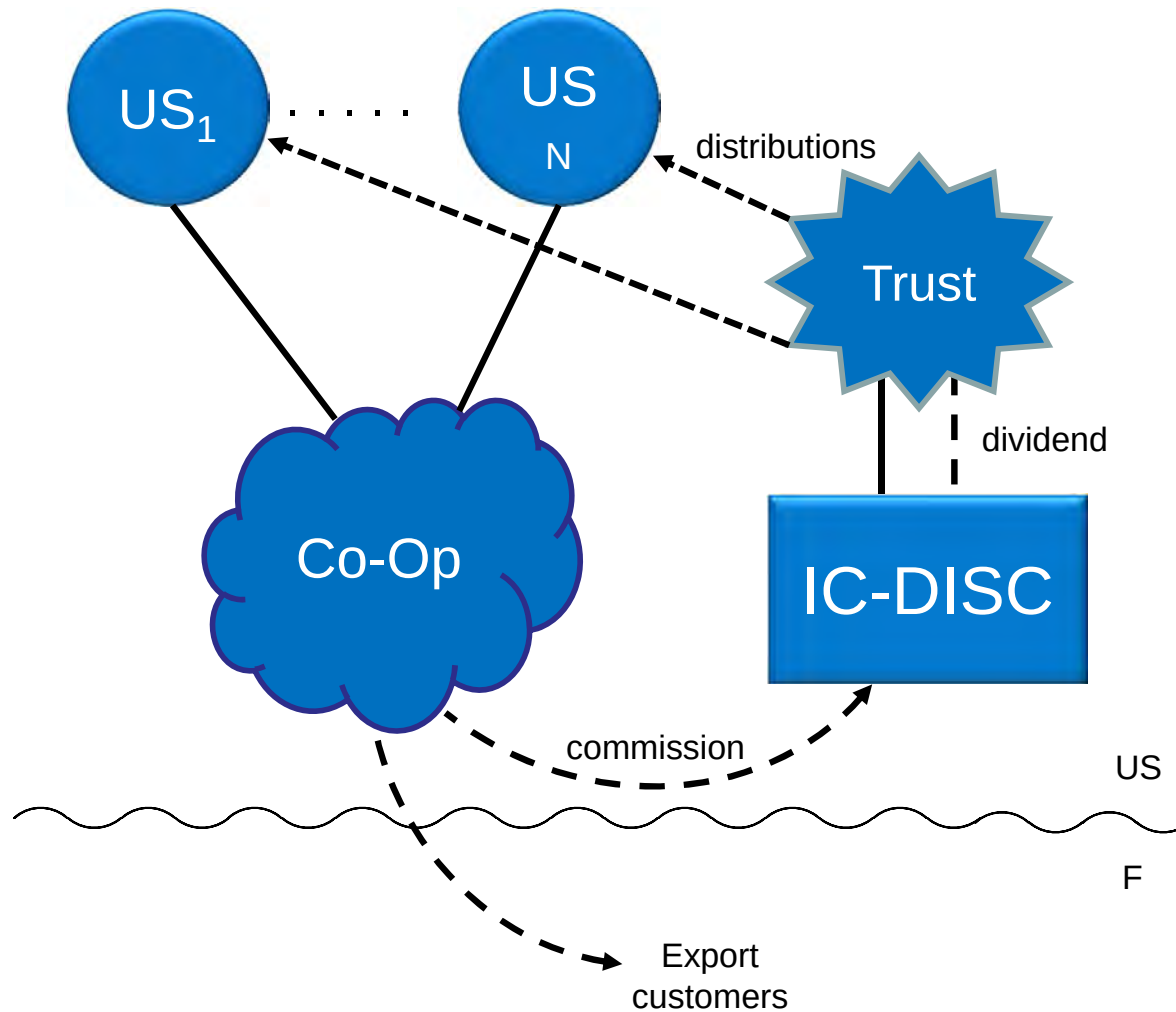
Gift Tax Implications?



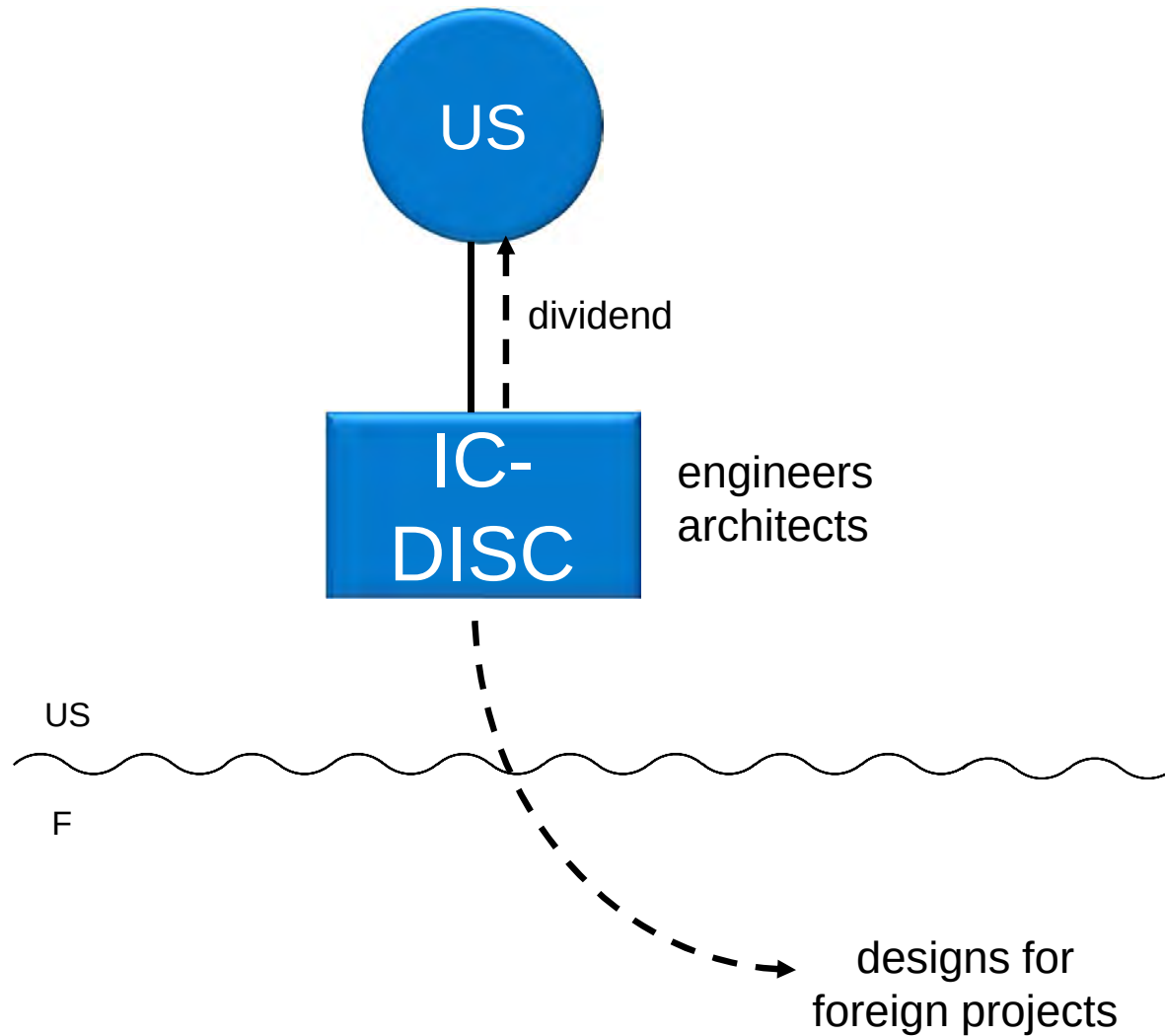
Non-Family Members



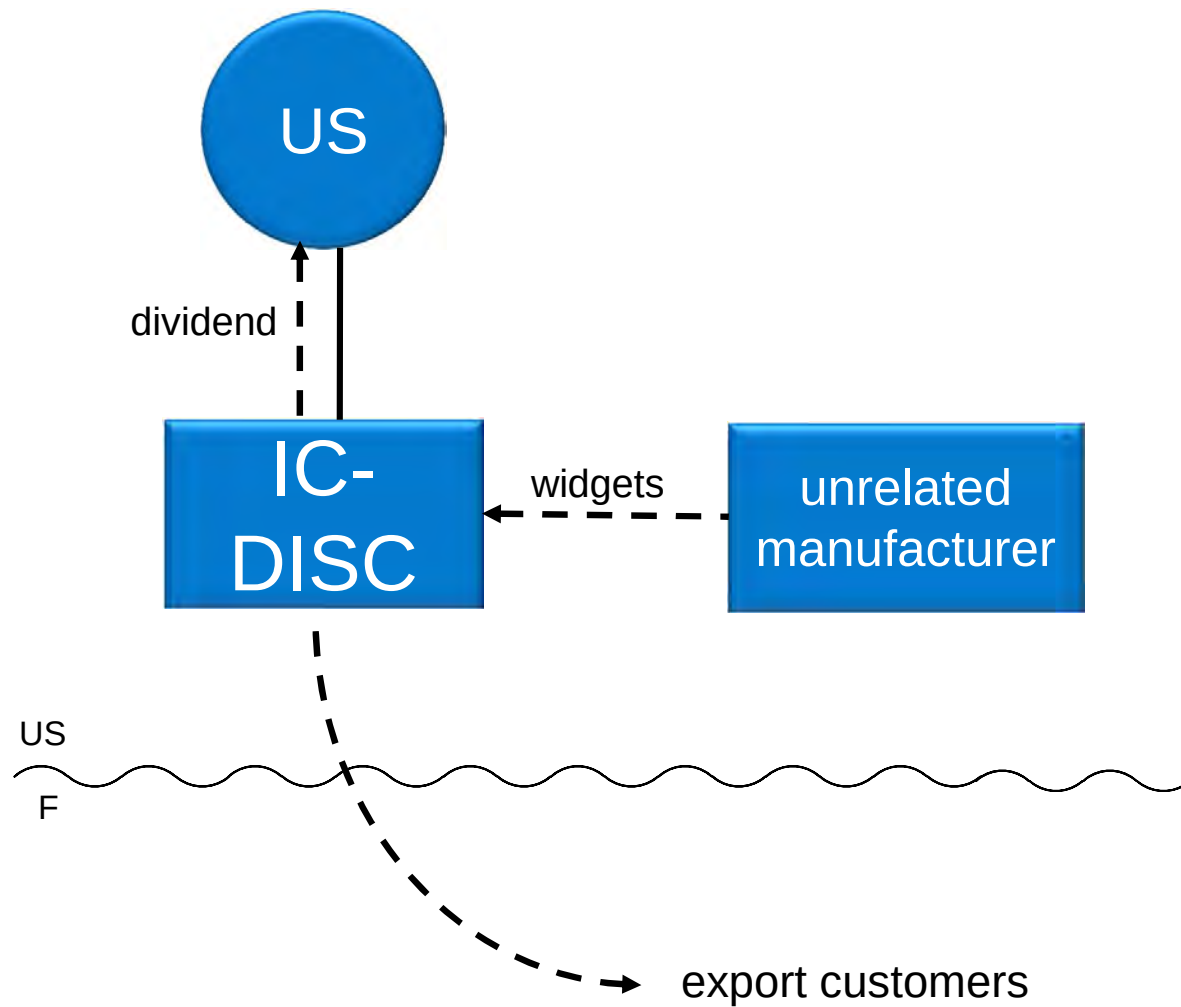
Trust For a Co-Op's Members



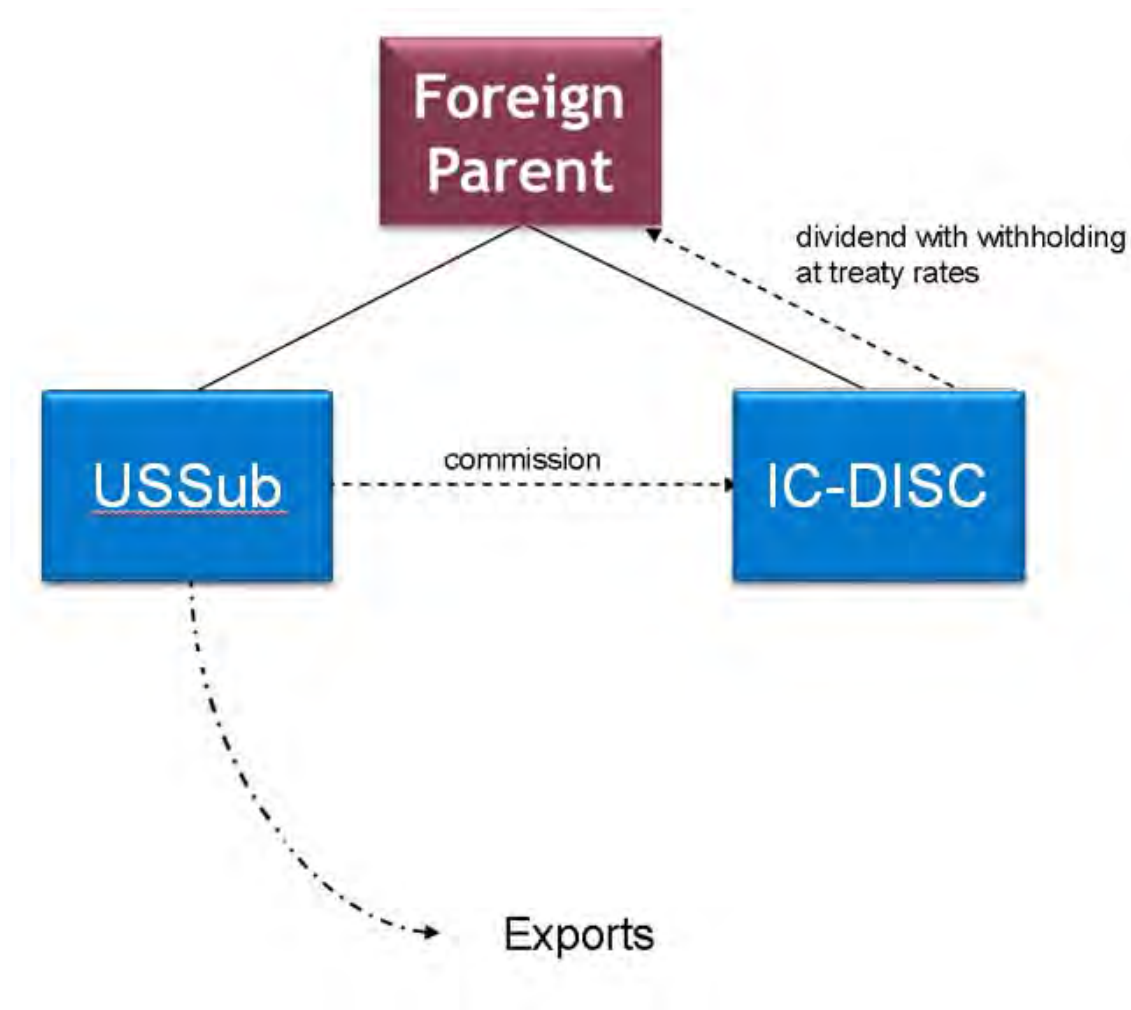
Architects and Engineers



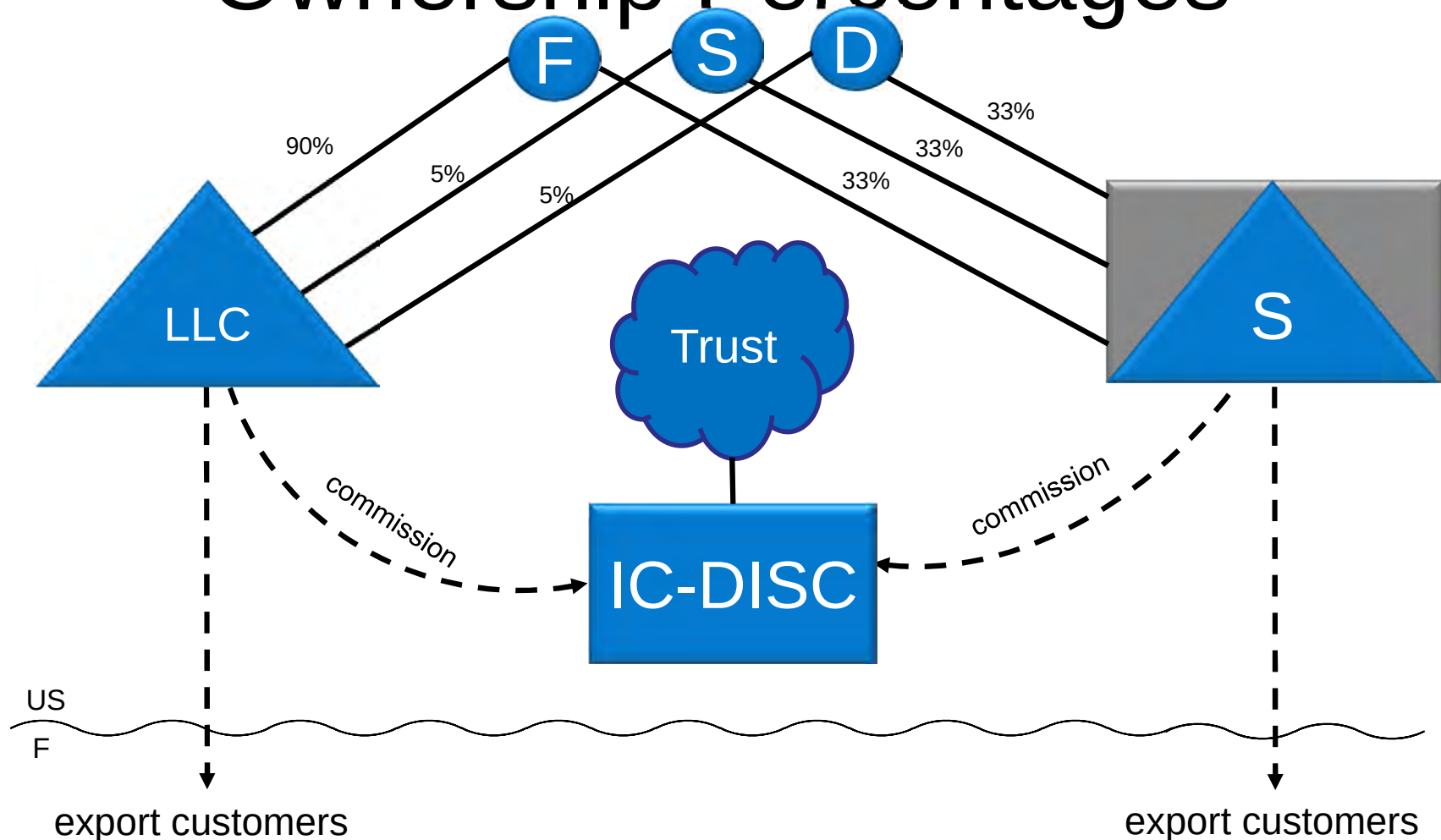
Pure Distributor



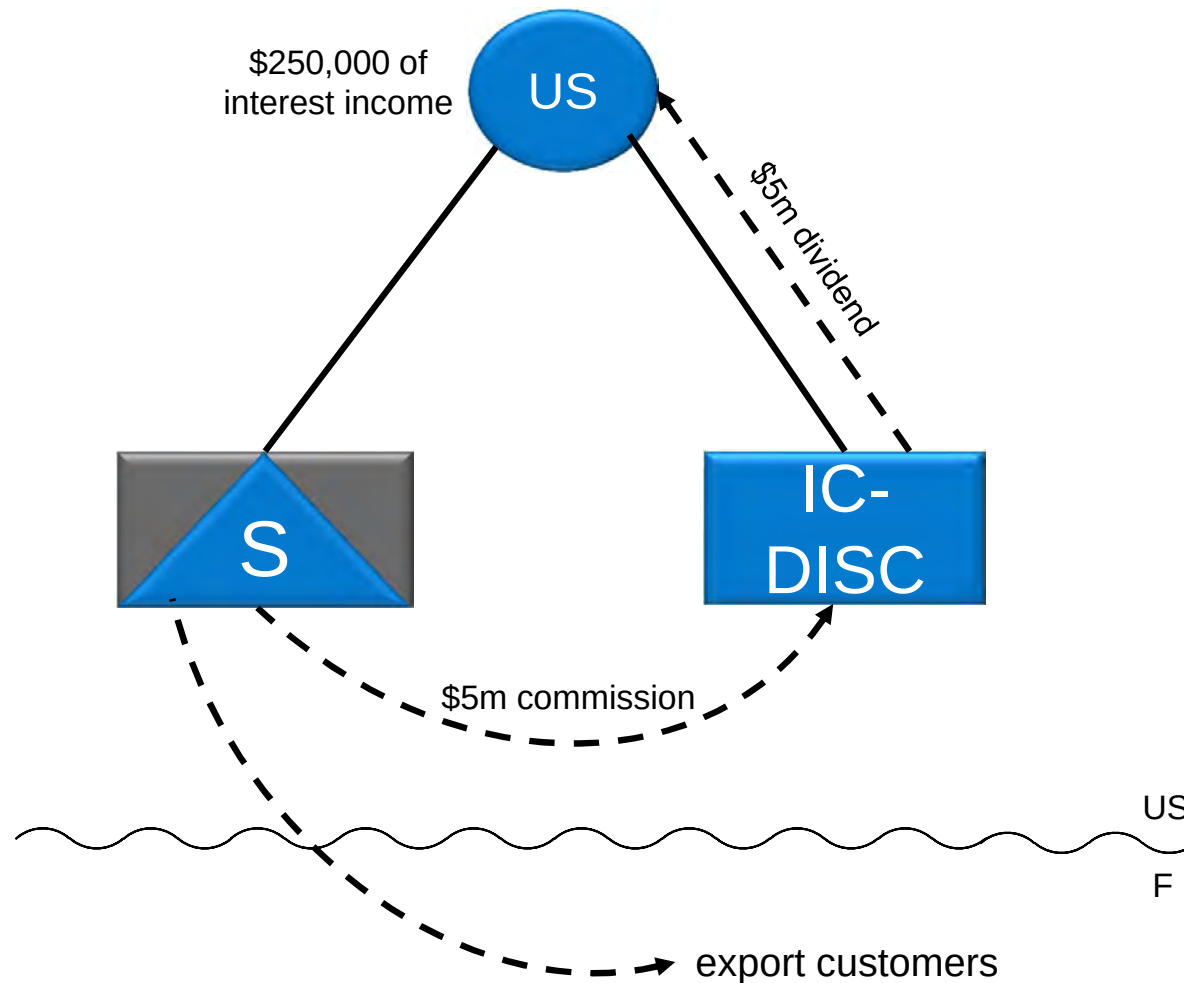
Inbound Treaty Benefits



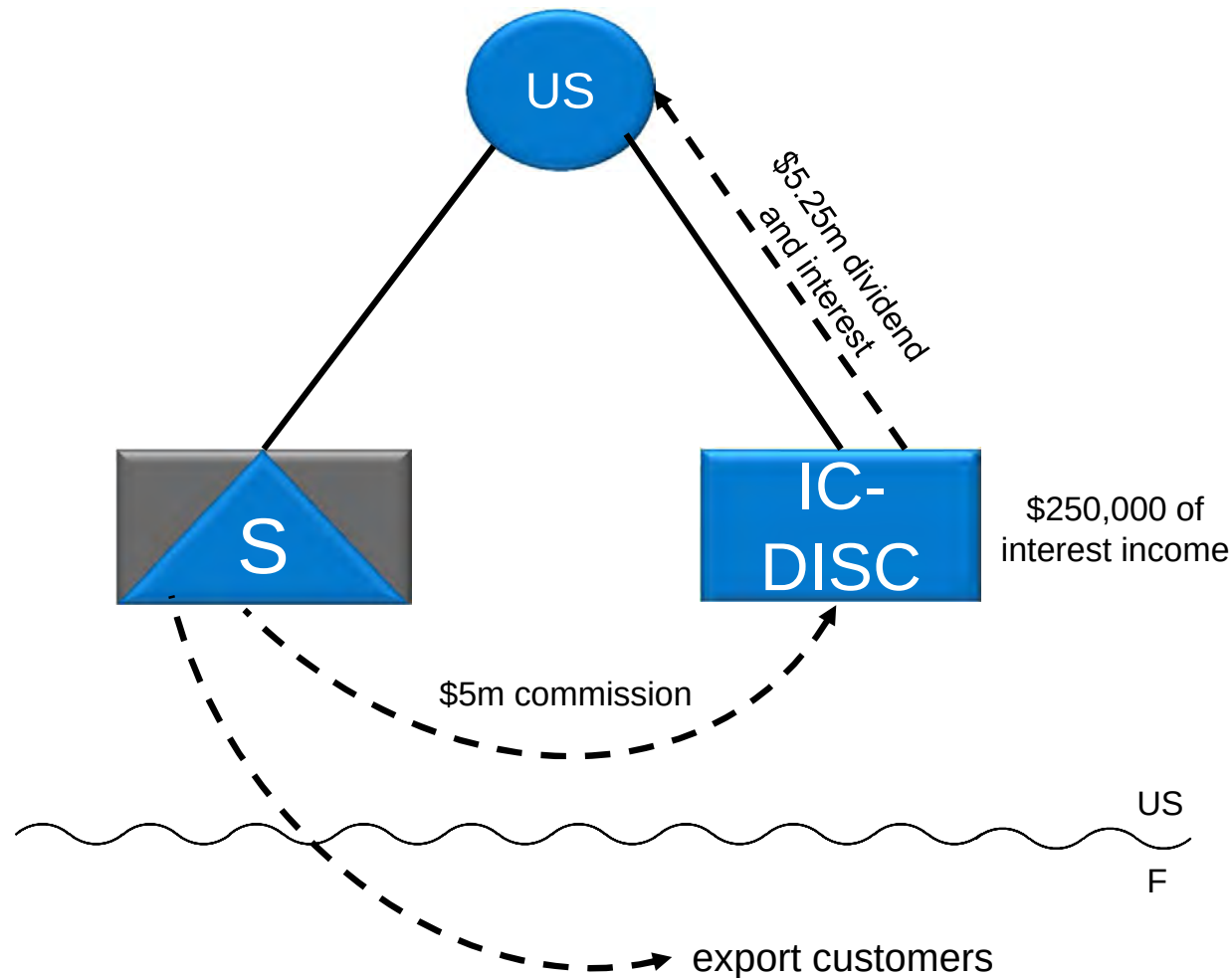
Use of a Trust With Varying Ownership Percentages



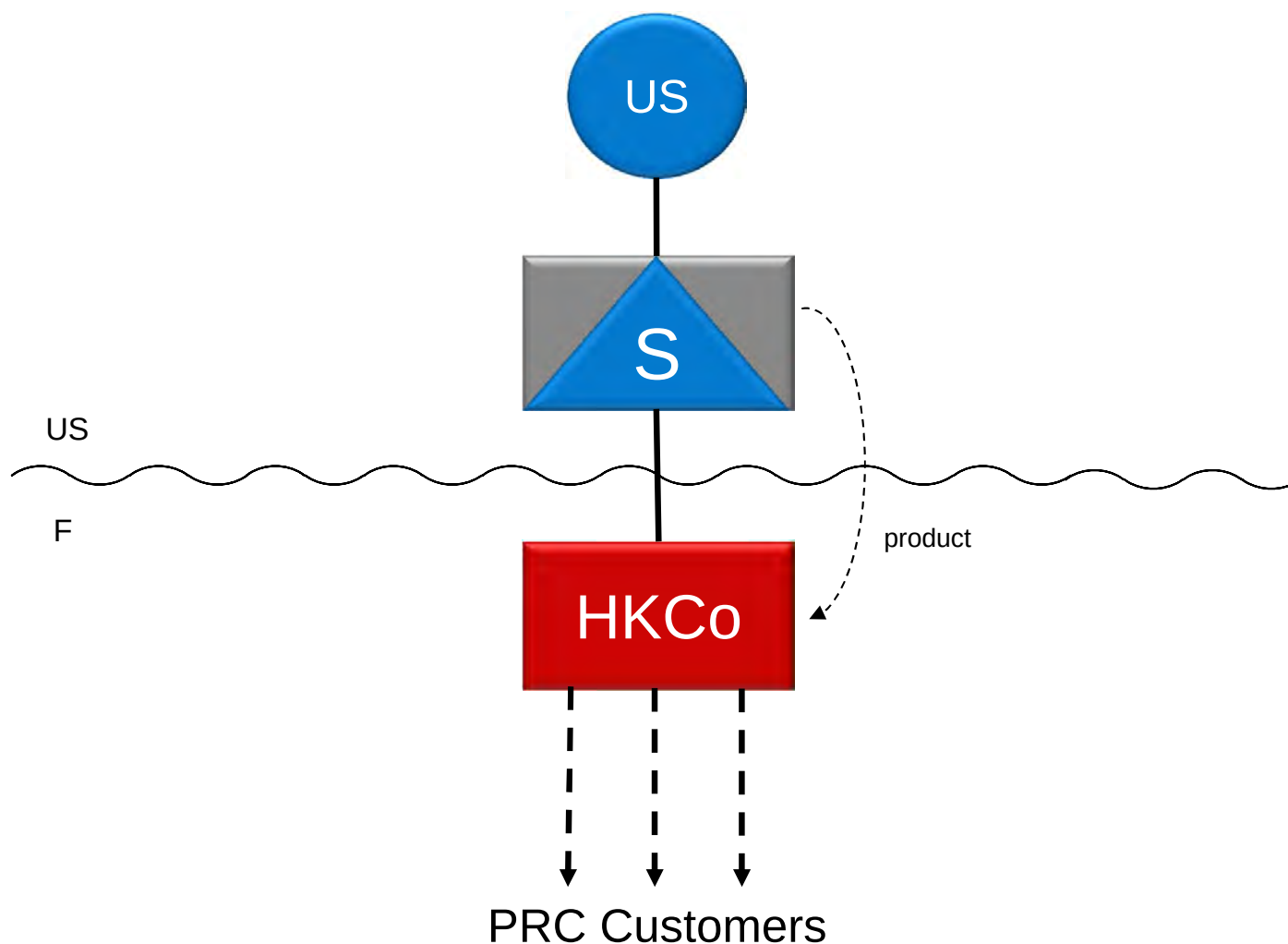
Non-Qualified if Tests Ignored



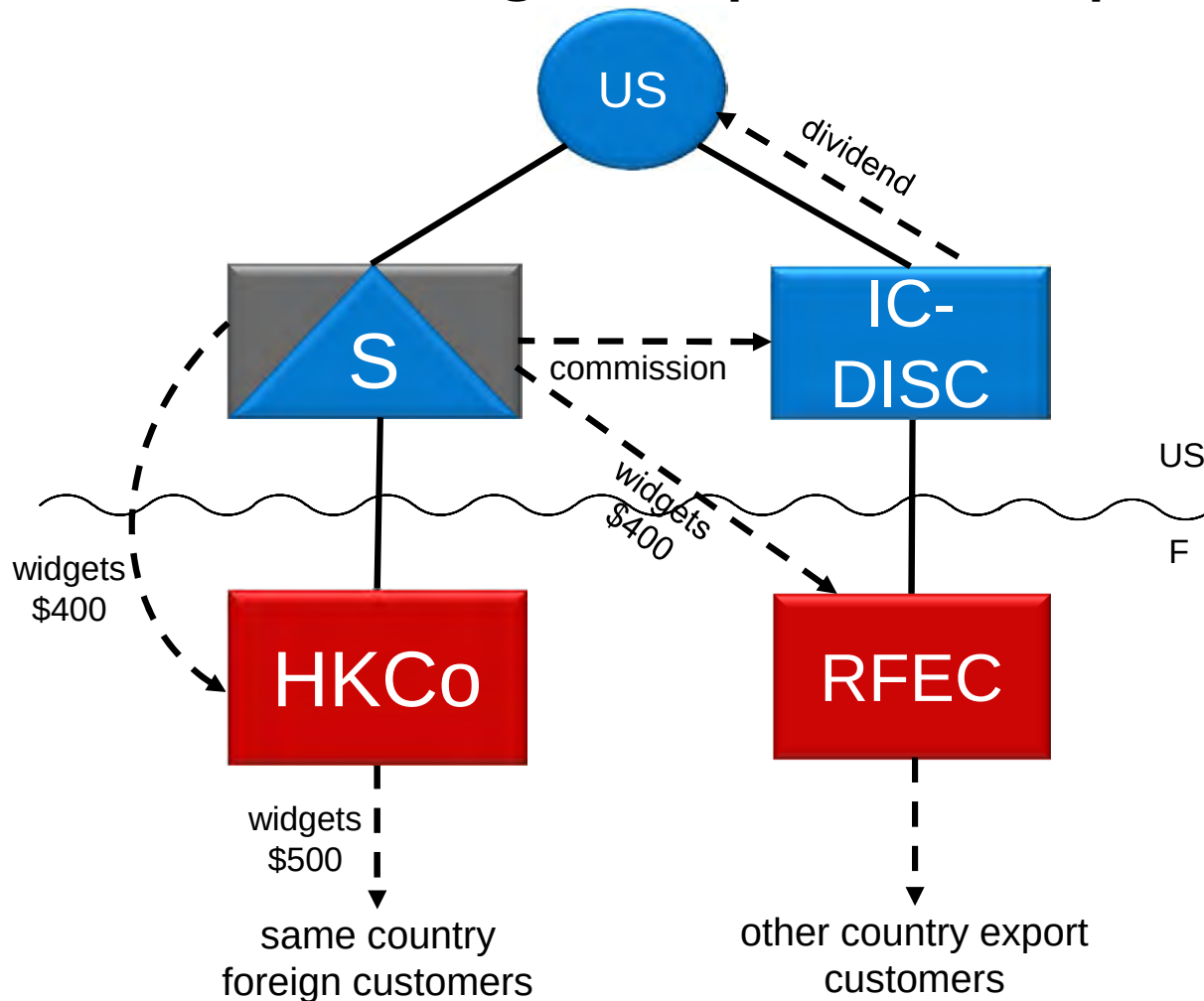
...but Benefits if Tests Satisfied



Subpart F Income Created



Avoid Subpart F Income With a Related Foreign Export Corporation





Implementation Considerations for the IC-DISC

- Incorporate the IC-DISC before the export sales begin
- Analyze the export sales
- Draft the commission agreement
- Prepare and timely file the Form 4876-A that elects IC-DISC status
- Prepare a manual that contains guidelines and a checklist/calendar

About Rob Misey

Robert Misey is Chair of the International Department for Reinhart Boerner Van Deuren and a member of the bar in California, Wisconsin, and the District of Columbia.



A graduate of the law schools at Vanderbilt University and Georgetown University, he is a former trial attorney for the Internal Revenue Service Chief Counsel (International) in Washington, DC. He is also the author of the books *A Practical Guide to U.S. Taxation of International Transactions* and *Federal Taxation: Practice and Procedure*.

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Chief Counsel

Tax Section – 19th Annual International Tax Symposium
Dallas- November 3 and Houston- November 4, 2016

Offshore Compliance Options including OVDP and the Streamlined Filing Compliance Procedures

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IRS Office of Chief Counsel
Austin, Texas
512-499-5281



Disclaimer

- The views expressed by the speaker do not necessarily reflect the views of the IRS or the Office of Chief Counsel.
- These slides are designed as shorthand aids to an oral or panel presentation and are not to be used or cited as precedent.



Objectives

- Broadly summarize Offshore Compliance Options Available to U.S. Taxpayers
- Describe the Offshore Voluntary Disclosure Program (OVDP)
- Describe the Streamlined Filing Compliance Procedures and the key differences between Streamlined Domestic Offshore (SDO) and Streamlined Foreign Offshore (SFO)
- Briefly highlight delinquent FBAR filing procedures and delinquent international information return filing procedures



Four Offshore Compliance Options

1. OVDP
 - Transition Streamlined
2. Streamlined Filing Compliance Procedures
 - Streamlined Foreign Offshore
 - Streamlined Domestic Offshore
3. Delinquent FBAR Submission Procedures
4. Delinquent International Information Return Submission Procedures

Reference: Options Available for U.S. Taxpayers with Undisclosed Foreign Financial Assets on IRS.gov



Offshore Compliance Options on IRS.gov

A screenshot of the IRS.gov website. The page has a green border. At the top left is the IRS logo. To the right of the logo is a search bar with the text "Search" and a magnifying glass icon. Below the search bar is a navigation bar with tabs for "Filing", "Payments", "Refunds", "Credits & Deductions", "News & Events", "Forms & Pubs", and "Help & Resources". On the left side of the page is a sidebar with links for "Employees", "Self-Employed", "International Taxpayers", "Military", "Parents", "Seniors & Retirees", and "Students". The "International Taxpayers" link is highlighted. The main content area has the title "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets" in a large, bold font. To the right of the title are icons for a heart, a plus sign, and a printer. Below the title is a paragraph of text explaining the implementation of FATCA and the IRS's efforts to ensure compliance. It then lists four options for addressing previous failures to comply with U.S. tax and information return obligations. Each option is a blue hyperlink. At the bottom of the main content area is a paragraph stating that each option is explained below and that the IRS encourages taxpayers to consult with professional tax or legal advisors. At the very bottom of the page is the text "Page Last Reviewed or Updated: 14-May-2015".

Subscriptions Language

Search

Filing Payments Refunds Credits & Deductions News & Events Forms & Pubs Help & Resources

Employees
Self-Employed
International Taxpayers
Military
Parents
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Students

Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets

The implementation of FATCA and the ongoing efforts of the IRS and the Department of Justice to ensure compliance by those with U.S. tax obligations have raised awareness of U.S. tax and information reporting obligations with respect to non-U.S. investments. Because the circumstances of taxpayers with non-U.S. investments vary widely, the IRS offers the following options for addressing previous failures to comply with U.S. tax and information return obligations with respect to those investments:

1. [Offshore Voluntary Disclosure Program](#);
2. [Streamlined Filing Compliance Procedures](#);
3. [Delinquent FBAR submission procedures](#); and
4. [Delinquent international information return submission procedures](#).

Each of these options is explained below. The IRS encourages taxpayers to consult with professional tax or legal advisors in determining which option is the most appropriate for them.

Page Last Reviewed or Updated: 14-May-2015



Statistics

- OVDP
 - Over 54,000 OVDP disclosures
 - Over \$8 billion collected
- Streamlined
 - More than 30,000 taxpayers made submissions since 2012
 - About 2/3 since expanded criteria in June 2014

Source of statistics- IR-2015-116 (10/16/2015)



OVDP – Key terms for all programs

- Preclearance through CI (not required)
- Amended/delinquent returns for disclosure period
 - Pass on criminal prosecution
 - Pay back taxes, accuracy-related penalty and/or delinquency penalties, and miscellaneous offshore penalty (MOP)
- IRS “certifies” the submission
 - Less than an examination
 - Review of amended returns
 - Review financial records
 - Verify FBAR reporting
 - Taxpayer cooperation essential



OVDP – Key terms for all programs

- Miscellaneous Offshore Penalty (MOP)
 - Determine Highest Aggregate Balance (HAB)
 - All assets related to tax noncompliance
 - Compute the MOP based on HAB ($\text{MOP \%} \times \$ \text{ in HAB}$)
- Close case with Form 906 Closing Agreement
 - Identifies offshore income
 - Includes accuracy-related or delinquency penalties
 - Applies MOP to specific year

Summary of OVDP Evolution

	2009 Offshore Voluntary Disclosure Program	2011 Offshore Voluntary Disclosure Initiative	2012 Offshore Voluntary Disclosure Program	Modified 2012 Offshore Voluntary Disclosure Program
CI protection	Yes	Yes	Yes	Yes
Information required for preclearance by CI	Name, address, date of birth, and TIN	Name, address, date of birth, and TIN	Name, address, date of birth, and TIN	Name, address, date of birth, TIN, telephone number, identifying information of all financial institutions at which undisclosed accounts were held, and identifying information of all foreign and domestic entities (e.g., corporations, partnerships, LLCs, trusts, foundations) through which undisclosed accounts were held
Penalty terms	Miscellaneous Title 26 offshore penalty of 20% in lieu of other applicable penalties	Miscellaneous Title 26 offshore penalty of 25% in lieu of other applicable penalties Reduced penalty of 5% offered to taxpayers meeting certain criteria deemed to be non-willful conduct Reduced penalty of 12.5% for taxpayers with accounts with balances below \$75,000	Miscellaneous Title 26 offshore penalty of 27.5% in lieu of other applicable penalties Reduced penalty of 5% offered to taxpayers meeting certain criteria deemed to be non-willful conduct Reduced penalty of 12.5% for taxpayers with accounts with balances below \$75,000	Miscellaneous Title 26 offshore penalty of 27.5% in lieu of other applicable penalties The miscellaneous offshore penalty increases to 50% if the taxpayer has or had an undisclosed foreign financial account held at a foreign financial institution or if the account was established with the help of a facilitator where the institution or facilitator has been publicly identified as being under investigation or cooperating with a government investigation.
Covered period	6 years	8 years	8 years	8 years
Closing agreement	Yes	Yes	Yes	Yes
Relief for taxpayers who did not timely elect to defer U.S. income tax on undistributed income earned by certain registered Canadian retirement and savings plans	No	No	Yes	Yes

Not used or cited as precedent.



2014 OVDP Key Modifications

- Increase information required for preclearance (FAQ 23)
- 50% offshore penalty in connection with public disclosures (FAQ 7.2)
 - Accounts with foreign financial institutions
 - Account established or maintained by a facilitator
- Eliminate the existing reduced penalty categories for certain non-willful taxpayers (FAQs 52 and 53)
- Payment of the offshore penalty at the time of the OVDP submission (FAQ 7)

Reference FAQ 1.1 for all significant changes to the 2012 OVDP.



2014 OVDP Key Modifications (cont.)

- Submit all account statements (voluminous account records may be provided on a CD) (FAQs 25 and 25.2)
- Changes to asset base and elimination of valuation discounts (FAQs 31 through 41)
- Emphasizes that protection from criminal prosecution is contingent on cooperation through the end of the process



Opt Out and Removal

- Statute extensions requested with OVDP submission in the event of opt out/removal - (FAQs 25 and 43)
- Cases that cannot be resolved in OVDP with a Form 906 (FAQ 51)
 - Opt Out - Taxpayer's choice
 - Removal - Service's choice
 - Procedures in place – see Opt Out and Removal Guide (link to guide is embedded in FAQ 51)



OVDP – Other Topics

- DOJ's Swiss Bank Program
 - 78 non-prosecution agreements with Swiss Banks
 - <https://www.justice.gov/tax/swiss-bank-program>
 - Swiss Bank Program yielded client-specific information from banks
 - IRS will leverage information for compliance efforts
- Recent additions to FAQ 7.2
- Cross-checking OVDP FAQ 23 preclearance requests
 - Follow through or lack thereof after preclearance requests may identify taxpayers with compliance issues



OVDP and Collection

- Program requires full payment of tax, interest and penalties including MOP (FAQ 7)
- Raise inability to full pay early in process (FAQ 20)
 - Form 433-A/B required
 - Propose payment arrangement with Collection's concurrence
 - Burden on taxpayer to establish inability to full pay
 - Filing bankruptcy before certification process may derail certification process



OVDP and Foreign Pension Issues

- If a practitioner takes the perspective that a foreign pension other than a Canadian RRSP/RRIF is excluded from the OVDP penalty base, provide the legal position with the OVDP submission



How do taxpayers handle mistakes made in earlier OVDP submissions?

- Request supplemental disclosure through current OVDP
 - Option 1: Provide new disclosure directly to CI
 - Option 2: Contact examiner who handled original disclosure, provide facts and any requested documents, and examiner will obtain program management concurrence



Reasons for 2014 Streamlined

- OVDP penalty structure was harsh for certain taxpayers
- Taxpayers who disagreed with penalty structure were:
 - Filing “quiet disclosures”
 - Entering OVDP then opting out
 - Remaining non-compliant
- 2012 Streamlined had narrow eligibility requirements
- 2014 Streamlined modifications greatly expanded eligibility



Modifications to Streamlined

“Our goal is to ensure we have struck the right balance between emphasis on aggressive enforcement and focus on the law-abiding instincts of most U.S. citizens who, given the proper chance, will voluntarily come into compliance and willingly remedy past mistakes.”

“We are considering whether our voluntary programs have been too focused on those willfully evading their tax obligations and are not accommodating enough to others who don’t necessarily need protection from criminal prosecution because their compliance failures have been of the non-willful variety.”

(Commissioner Koskinen, 6/18/14 , Quote from U.S. Council for Int’l Business – OECD Int’l Tax Conference)



Streamlined Procedures Eligibility

- U.S. Individuals and estates only
- Failed to report foreign financial assets or pay all tax due in respect of those assets
- Able to certify failures are related to non-willful conduct
- Not currently under IRS examination or criminal investigation
- Have a valid Taxpayer Identification Number



SSN/TIN required for submissions

If a taxpayer is not eligible for a Social Security Number (SSN) and does not already have an ITIN:

- Submit an application for an ITIN along with the required tax returns, information returns, and other documents filed under these Streamlined Procedures.
- Search “ITIN” on www.irs.gov for more information.

If a taxpayer is eligible for an SSN and does not have one, first obtain an SSN before making a submission under the Streamlined Procedures. If a taxpayer eligible for an SSN makes a Streamlined Submission without an SSN, the return will be processed subject to penalties applicable outside of the Streamlined Procedures.



Certifications for 2014 Streamlined

- Form 14654 – SDO
 - Requires foreign financial asset information for 6 year period
 - Includes computation of MOP
- Form 14653 – SFO
- Forms have been revised several times in the last 2 years
 - Feb. 2016: revision emphasize that taxpayers MUST include narrative statement of facts and provide guidance on providing a complete narrative
 - Latest version - June 2016



Certifications required on Forms 14653 and 14654

Both forms require taxpayers to agree to terms and represent certain facts:

- Retaining records for 6 years and providing records upon request
- Representing that failures were due to non-willful conduct
- Acknowledging possibility of examination



Definition of “Non-Willful” for Streamlined Procedures

“Non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.”

- Based on facts and circumstances of each case
- No one fact controls analysis
- Press coverage includes 2014 TNT 212-7, document 2014-26106 (11/3/2014)



Statement of Facts for Non-Willful Certifications

- Written statement signed under penalties of perjury
- Certifying non-willful conduct with respect to all foreign activities and assets
- Provide reasons for the income and information reporting failures
- Specifically identify professional advisor and advice relied upon



Explaining Non-Willful Conduct

SFO FAQ #6 and SDO FAQ #13 provide guidance

- Provide specific reasons and background
- Include the whole story including favorable and unfavorable facts
- Explain the source of funds in all foreign financial accounts/assets
- Explain contacts with the account/asset including withdrawals, deposits, and investment/management decisions



Explaining Non-Willful Conduct (cont'd)

- What if I checked no on Schedule B?
- What if I owned or controlled a foreign entity?

Part III Foreign Accounts and Trusts

(See
instructions on
back.)

You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

7a At any time during 2015, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions

If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements

b If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ►

8 During 2015, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back

Yes No

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 17146N

Schedule B (Form 1040A or 1040) 2015



SFO vs. SDO

SFO – Streamlined Foreign Offshore

- Meet non-residency requirement
- Provide delinquent or amended income tax returns (Form 1040/1041)
- Forms 1040NR are not accepted
- No penalties

SDO – Streamlined Domestic Offshore

- Do not meet SFO residency requirements
- Must have filed income tax returns before submitting amended returns through procedures
- 5% penalty on assets reportable on FBAR/F. 8938
(explained infra)



SFO Non-Residency Requirements

Individuals who are U.S. citizens or lawful permanent residents

- In any one or more of the most recent three years
 - Not have a U.S. abode and
 - Physically outside the United States for at least 330 full days
- Both taxpayers on joint return must meet residency requirements
- Snowbird Issue— some taxpayers fail SFO if present in US more than 35 days/year but cannot use SDO because they did not file income tax returns



SDO Miscellaneous Offshore Penalty

5% Title 26 miscellaneous offshore penalty applied to assets:

- in the covered FBAR period if the asset should have been, but was not, reported on an FBAR (FinCEN Form 114) for that year
- in the covered tax return period if the asset should have been, but was not, reported on a Form 8938 for that year
- in the covered tax return period if the asset was properly reported for that year, but gross income in respect of the asset was not reported in that year

See SDO FAQ 6

Year end account/asset values are used to aggregate assets

Exceptions for assets:

- Accounts with no financial interest are excluded (e.g. mere signature authority)- see SDO FAQ 1
- Canadian RRSP/RRIF accounts – see SDO FAQ 8



SFO Hypothetical

Mr. Smith was born in the United States but moved to Canada with his parents when he was five years old, lived there ever since, and does not have a U.S. abode. Assume Mr. Smith meets the non-residency requirement applicable to individuals who are U.S. citizens or lawful permanent residents.

Can Mr. Smith use Streamlined SFO? If so, what should he submit?



SDO Hypothetical

Acct #1 - tax non-compliant

Acct #2 – tax compliant

Rental Property – tax non-compliant

Land – tax compliant

Assume:

TP failed to file all
FBARs/F8938s

	2008	2009	2010	2011	2012	2013
For. Bank Acct #1	1,400,000	1,850,000	1,400,000	1,500,000	1,900,000	2,050,000
For. Bank Acct #2	200,000	200,000	200,000	200,000	200,000	200,000
Total	<u>1,600,000</u>	<u>2,050,000</u>	<u>1,000,000</u>	<u>1,700,000</u>	<u>2,100,000</u>	<u>2,250,000</u>

HAB Year: 2013

MOP Penalty: \$112,500 ($\$2,250,000 \times 5\%$)

Streamlined looks at FFAs for last 6 years FBAR and 3 years income tax/F8938

Not to be used or cited as precedent.



OVDP and Streamlined Refinements

- FAQs
 - Refined, modified, new FAQs added based on feedback from stakeholders
- Form changes and new forms (e.g., Form 14708)



FAQs for Streamlined and Delinquent Return Procedures

- Initial Streamlined FAQs released on 10/8/14, additional FAQs released 7/16/15 and 1/7/16
- Key FAQs for SDO
 - FAQ 1: Assets included in penalty base
 - Assets in which taxpayer had no financial interest are not included in penalty base
 - FAQ 4: Valuing entities
 - Disregarded entities- look through to the underlying financial accounts
 - Corporations- use stock value (no discounts per FAQ 5)
 - FAQ 7: Allows recently compliant taxpayers (2013, 2012, 2011) to enter Streamlined and pay 5% for earlier years
 - Recurring pattern for certain Swiss account holders



FAQs (cont'd)

- SFO FAQ 7 and SDO FAQ 14 provide a procedure for a joint filer to make an individual Streamlined submission
 - Joint amended income tax returns with only one signature
 - Amended income tax returns must reflect increase in tax
 - Explain circumstances
 - Write “SFO FAQ 7” or “SDO FAQ 14” in red ink on amended returns and certification form



Streamlined FAQs (cont'd)

- SFO FAQ 9 and SDO FAQ 16 provide a procedure for correcting mistakes in earlier Streamlined submissions
 - Explain all facts and circumstances concerning the error in the original Streamlined submission
 - Opportunity to self-correct before IRS identifies issue and initiates examination
 - On certification form write “amended” in red ink
 - On tax returns write “Amended Streamlined Domestic Offshore” or “Amended Streamlined Foreign Offshore”



Rev. Proc. 2014-55

Certain Canadian Retirement Plans

- Rev. Proc. 2014-55 provides procedures for Canadian retirement plans
 - Deemed treaty election for eligible taxpayers
 - Form 8891 obsolete
 - FBARs and Form 8938 still required
- 2014 OVDP and Streamlined FAQs take into account Rev. Proc. 2014-55
 - SDO FAQ 12 addresses reconsideration process for SDO submissions that paid MOP on RRSP accounts
 - Form 14708



Streamlined – Post Submission

- Unlike OVDP, Streamlined Procedures cases do not involve Service personnel certifying submissions and do not culminate in a closing agreement
- Streamlined Procedures attempt to normalize return processing
 - Returns are processed by Submission Processing
 - Returns may be selected for examination



Trending Problems Observed with Streamlined Submissions

- Insufficient narrative statement of fact
 - Provide a complete story
 - See SFO FAQ 6 and SDO FAQ 13 for guidance
- OVDP MTM PFIC computation used for Streamlined submissions
- Filing Forms 1040NR



Trending Problems (cont'd)

- Related parties selecting different compliance paths (OVDP and Streamlined) attempting to allocate ownership of asset
 - Example of impermissible allocation: Father, Brother, and Sister all have signature authority over same Swiss bank account. Bank account has \$1,000,000 balance for all years. Father enters OVDP and claims he's 50% owner of account, paying MOP at rate of 27.5% on \$500,000. Brother and Sister make SDO submissions, each paying SDO MOP at rate of 5% on \$250,000 each.



Trending Problems (cont'd)

- Mistakes with SDO penalty base

“A foreign financial asset is subject to the 5-percent miscellaneous offshore penalty in a given year in the covered FBAR period if the asset should have been, but was not, reported on an FBAR (FinCEN Form 114) for that year. A foreign financial asset is subject to the 5-percent miscellaneous offshore penalty in a given year in the covered tax return period if the asset should have been, but was not, reported on a Form 8938 for that year. A foreign financial asset is also subject to the 5-percent miscellaneous offshore penalty in a given year in the covered tax return period if the asset was properly reported for that year, but gross income in respect of the asset was not reported in that year.”

quote from <https://www.irs.gov/individuals/international-taxpayers/u-s-taxpayers-residing-in-the-united-states>



Trending Problems – Mistakes with SDO Penalty (cont'd)

- Submissions that fail to include in the SDO penalty base foreign financial assets that were not reported on FBARs but were tax compliant
 - Some representatives are pointing out their creativity with footnotes
 - Other representatives do not make their creativity clear and later argue including tax compliant accounts in SDO penalty base is “unfair”



Trending Problems – Mistakes with SDO Penalty (cont'd)

- Failure to include assets in the penalty base may result in
 - IRS reversing beneficial penalty provisions of procedures
 - Examination
- What should a representative do if an asset was omitted from the SDO penalty base?
 - Follow the procedures in SDO FAQ 14 to provide an amended certification



Recurring Practitioner Question about Non-willful Certifications

Question: Does feedback on non-willful certifications for OVDP Transition Streamlined requests indicate how the Service reviews non-willful certifications for new Streamlined submissions?

Answer: The review of non-willful certifications in OVDP Transition Streamlined cases is different from the review of new Streamlined submissions.



Delinquent FBAR Procedures

- File all FBARs electronically with FinCEN
 - <http://bsaefiling.fincen.treas.gov/main.html>
 - BSA e-filing system offers an instruction booklet that provides line by line instructions for filing FBARs
- On cover page select reason for filing late
- Include statement explaining why filing late



May 13, 2015 FBAR Interim Guidance

- Interim guidance discusses general approach for FBAR penalties
- Penalties are “based on the facts and circumstances of each case”
- Attachment 1, heading (2) “Penalty for Willful Violations”
 - “In most cases the total penalty ... will be limited to 50 percent of the highest aggregate balance...”
 - “Examiners may recommend a penalty that is higher or lower than 50 percent of the highest aggregate account balance ... In no event will the total penalty amount exceed 100 percent of the highest aggregate balance... .”
- Highest aggregate balance occurs on any day during the reporting year



May 13, 2015 FBAR Interim Guidance

- Attachment 1, heading (3) “ Penalty Amount for Nonwillful Violations”
 - “For most cases involving multiple nonwillful violations, examiners will recommend one penalty for each open year ... and the penalty for each year will be limited to \$10,000.”
 - “In no event will the total amount of the penalties for nonwillful violations exceed 50 percent of the highest aggregate balance of all unreported foreign financial accounts... .”
- See 2014 OVDP FAQ 50.1 for application to OVDP FAQ 50 analysis



Delinquent Information Return Procedures

Taxpayers who:

- have not filed required international information returns,
- have reasonable cause,
- are not under civil examination/criminal investigation, and
- have not been contacted about the delinquent information returns

May file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file

- Normalizes handling delinquent information returns
- Penalties may be imposed if the Service does not accept the explanation of reasonable cause

Summary of Offshore Compliance Options

	Offshore Voluntary Disclosure Program	Streamlined Filing Compliance Procedures		Delinquent FBAR Procedure	Delinquent International Information Return Procedure
		U.S. Persons Living Outside the United States	U.S. Persons Living Inside the United States		
Taxpayers for whom the compliance option is designed	Bad actors	Persons living outside the United States who were not aware of their U.S. tax obligations	Non-willful actors	Persons not seeking treatment under OVDP or Streamlined Procedures but who failed to file FBARS	Persons not seeking treatment under OVDP or Streamlined Procedures but who failed to file international information returns
Penalty terms	Miscellaneous Title 26 offshore penalty of 27.5% in lieu of other applicable penalties	No Penalties	Miscellaneous Title 26 offshore penalty of 5% in lieu of other applicable penalties	No automatic penalties; taxpayer provides statement of why late	No automatic penalties; taxpayer provides statement of reasonable cause
Covered period	8 years	3 years for income tax returns; 6 years for FBARS	3 years for income tax returns; 6 years for FBARS	Up to taxpayer	Up to taxpayer
CI protection	Yes	No	No	No	No
Closing agreement	Yes to be used or cited as precedent.	No	No	No	No



OVDP and Streamlined Resources

- IRS.gov
 - <http://www.irs.gov/Individuals/International-Taxpayers/Options-Available-For-U-S--Taxpayers-with-Undisclosed-Foreign-Financial-Assets>
- FAQs
- OVDP and Streamlined Hotline
267-466-0020 (new phone number)



FBAR Resources

FinCEN website:

www.FinCEN.gov

• FinCEN Resource Center:

1-800-767-2825 or (703) 905-3591

FRC@fincen.gov



Webinar Resources

- Webinar on filing FBARs (June 4, 2014)
 - <http://www.irsvideos.gov/ElectronicFBAR/>
- Webinar on Streamlined Filing Compliance Procedures (May 11, 2016)
 - <https://www.webcaster4.com/Webcast/Page/490/14723>
 - If link does not work, email Dean Burke at Dean.C.Burke@irs.gov for more information
- Webinar on “Overseas Filings for US Taxpayers” covering filing requirements, claiming the Foreign Earned Income Exclusion and Foreign Tax Credit, and foreign financial account reporting requirements (May 25, 2016)
 - <https://www.webcaster4.com/Webcast/Page/490/14725>



Questions from Audience



Presentation:

“SECTION 385 TRAPS & PITFALLS”

19TH ANNUAL INTERNATIONAL TAX SYMPOSIUM

STATE BAR OF TEXAS

Professor Bret Wells

November 3 & 4, 2016



Overview

Section 385(a): “The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title **as stock** or **indebtedness** (or as **in part stock** and **in part indebtedness**).

Section 385(b): includes a list of non-exhaustive factors that may be taken into account.

Section 385(c): issuer’s characterization of an instrument is binding on the holder.

1. Enacted. See Tax Reform Act of 1969, PL 91-172, 83 Stat. 487

- a. Amended by Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106 to expressly authorize Secretary to treat an instrument as part stock / part debt.
- b. Amended by Energy Policy Act of 1992, Pub. L. 102-486, §1936(a), 106 Stat. 3032, which added Section 385(c) to provide that the issuer’s characterization of an interest is binding on the issuer and all holders (but not the Secretary).

2. Prior Effort:

- a. Proposed: Notice of Proposed Rulemaking, 45 Fed. Reg. 18,959 (May 24, 1980)
- b. “Finalized:” TD 7747, 45 Fed. Reg. 86,438 (Dec. 31, 1980); amended by TD 7774, 46 Fed. Reg. 24,945 (May 4, 1981); amended by TD 7801, 47 Fed. Reg. 147 (Jan. 5, 1982); amended by TD 7822, 47 Fed. Reg. 28,915 (July 2, 1982)
- c. Withdrawn: TD 7920, 48 Fed. Reg. 50,711 (Nov. 3, 1983)

3. New Effort: a. Notice of Proposed Rulemaking, 81 Fed. Reg. 20,912 (April 4, 2016).

- b. “Finalized” T.D. 9790, 81 Fed. Reg. 72858 (Oct. 21, 2016)



Proposed Regulations: Enormous Number of Public Comments

An avalanche of comment letters attacked the proposed regulations. Some highlights of the critical comments included the following:

1. The proposed regulations used factors that were not specifically contemplated when section 385 was enacted and achieve objectives other than those contemplated at the time of section 385's legislative enactment.
2. The proposed regulations apply to a broad range of transactions other than just earning stripping transactions and corporate inversion transactions; thus, the breadth of the proposed regulations creates unduly harsh results in non-objectionable fact patterns.
3. The proposed regulations would apply to a significant number of ordinary business transactions and would negatively impact common treasury operations such as cash pooling arrangements.
4. The bifurcation rule was roundly criticized.



Procedural Issues

FOIA Type Litigation already has existed to acquire documents related to the 1980s regulatory project on Section 385. See *Judkins v. IRS*, D.D.C. No. 1:16-cv-01794 (Sept. 8, 2011).

APA challenge?

Cf., *Chamber of Commerce and Texas Association of Business v. IRS*, No. 1:16-cv-944 (D. Ct. Tex. Aug. 4, 2016) (suit to invalidate regulations issued under section 7874 on grounds that the notice and comment period of the APA were not followed).

Assessing Possible APA Challenge to the Final Regulations:

1. The preamble to the final regulations is voluminous and systematically addresses the submitted comment letters in mind-numbing detail. See 83 Fed. Reg. 72,858-72,950 (92 pages in federal register type-set print).
2. The final regulations (i) reserve on the most controversial aspects of the proposed regulations, significantly expanded exceptions to the funding rule, and relaxed the most onerous aspects of the documentation rules to address the harsh impacts on treasury management operations.

Conclusion (to this speaker): It will be difficult to argue that the Treasury Department did not seriously consider public comments.



Major Components of Final Regulations

The controversial final regulations under section 385 have the following main parts:

- I. Operating rules (Reg. §1.385-1 and -2(d) and -3(g)(3)):** the final regulations restricted the definition of an Expanded Group Instrument (EGI) to include only certain instruments issued by a “covered member” (a domestic issuer), so foreign issuer debt instruments are not addressed. The **bifurcation rule** and the **modified expanded group rules**, which were very controversial aspect of the proposed regulations, were **deleted** in the final regulations.
- II. Documentation and Maintenance Requirements (Reg. §1.385-2):** at their core, these rules remain unchanged, but some meaningful modifications were made.
- III. Per se and Funding rules (Reg. §1.385-3):** the final regulations retained these rules but limited their recharacterization of debt into stock to only those specified transactions where debt is issued by a “covered member” (US issuer).
- IV. Consolidated group rule (Reg. §1.385-4)** exception to these rules remains unchanged.
- V. General Anti-Abuse Rule (Reg. §1.385-3(b)(4)):** Debt issued with a principal purpose of avoiding the application of -2 or -3 are subject to being treated as stock.



Operational Rules of Reg. §1.385-1: Expanded Group and “Covered Member”

Expanded Group (Reg. §1.385-1(c)(4))

Utilizes a unique definition that starts with section 1504(a), incorporates section 318 attribution principles, but then “reserves” on how to apply the downward attribution principles of section 318(a)(3).

Implication: Reservation on section 318(a)(3) appears to have the effect that an EGI is not created between a brother-sister arrangement that is controlled by a noncorporate owner, nor does it appear to allow for attribution through controlled partnerships.

Covered Member (Reg. §1.385-1(c)(2))

A covered member is a US domestic corporation or a DRE that is owned by a covered member. In the definition of a “covered member,” the regulations “reserve” (have a place-holder) for non-US issuers. See Reg. §1.385-1(c)(2)(ii).



“Reserved” On Foreign Issues: What is the Loadstar to Guide Foreign-To-Foreign Base Erosion?

Proposed Regulations articulated this rationale:

“In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income. An example of the latter type of transaction could involve the distribution of a note from a first-tier CFC to its United States shareholder in a taxable year when the distributing CFC has no earnings and profits (although lower-tier CFCs may) and the United States shareholder has basis in the CFC stock. In a later taxable year, when the distributing CFC had untaxed earnings and profits (such as by reason of intervening distributions from lower-tier CFCs), the CFC could use cash attributable to the earnings and profits to repay the note owed to its United States shareholder. The taxpayer takes the position that the note should be respected as indebtedness and, therefore, that the repayment of the note does not result in any of the untaxed earnings and profits of the CFC being taxed as a dividend to the United States shareholder.”

Final Regulations: Foreign Issuers [Reserved]

“The Treasury Department and the IRS have determined that the application of the final and temporary regulations to indebtedness issued by foreign corporations requires further study. Accordingly, the final and temporary regulations apply only to EGIs and debt instruments issued by members of an expanded group that are domestic corporations (including corporations treated as domestic corporations for federal income tax purposes, such as pursuant to section 953(d), section 1504(d), or section 7874(b)), and reserve on the application to EGIs and debt instruments issued by foreign corporations. The final and temporary regulations achieve this result by creating a new term “covered member,” which is defined as a member of an expanded group that is a domestic corporation, and reserves on the inclusion of foreign corporations. One comment questioned how the proposed regulations would apply to U.S. branches of a foreign issuer. Although it is possible to increase the debt attributable to a U.S. branch through issuances of debt by the foreign owner to a related party, the various requirements on allocating liabilities between a branch and its home office (whether under the Code or a relevant bilateral tax treaty) raise unique issues. This preamble does not address those issues because the final and temporary regulations.”

This “debate” has not been settled, so expect further evolution here.



Operating Rules as to Instruments: Applicable Instrument, EGI, and Covered Member

1. **Applicable Instruments (Reg. §1.385-2(d)(2)):** Any instrument issued in the form of debt but excludes under -2(d)(2)(ii) the following: (A) intercompany debt held within a US consolidated group, (B) production payments treated as debt under §636, (C) a “regular interest in a real estate investment trust described in §860G(a)(1), (D) debt created by reason of a transfer pricing adjustment, and (E) any other instrument specifically and explicitly treated as debt under US tax laws.
1. **Expanded Group Interest (“EGI”) (Reg. §1.385-2(d)(3)).** An applicable instrument issued by a member of the expanded group to another member of the expanded group.
2. **Documentation & Maintenance Requirements and Funding & Per Se Rules** then further restrict the application of the final regulations to only an EGI issued by a “covered member.” See Reg. 1.385-2(a)(3) and -3(a)(3)(i).

The effect of the above tri-partite definition is that the final regulations **exclude**:

- Instruments issued by non-captive REITS and RICS
- Instruments issued by regulated banks that comply with
- Instruments issued by regulated insurance companies
- Instruments issued within a US consolidated group
- Instruments issued by foreign corporations



Operating Rules of Reg. §1.385-1: “Expanded Group”

2. **Expanded Group (“EG”) (Reg. §1.385-1(c)(4))** means one or more chains of corporations (other than an S corporation) connected through stock ownership with a common parent corporation that is not a RIC, REIT or S corporation (an “Expanded Group Parent” or “EGP”), but only if—
- a) The EGP owns directly or indirectly 80% of the vote or value in at least one of the other corporations; and
 - b) Stock meeting the 80% vote or value requirement in each of the other corporations (except the expanded group parent) is owned directly or indirectly by one or more of the other corporations.
2. **Controlled Partnership (“CP”) (Reg. §1.385-1(c)(1))** is a partnership in which at least 80% of the capital or profits interest are owned directly or indirectly by one or more members of an EG. CP is not a covered member.
2. **Indirect Ownership (Reg. §1.385-1(c)(4)(iii))** is determined using section 318(a) but with the following exceptions: (i) no family attribution; (ii) threshold for upstream attribution is reduced to 5%, and (iii) option attribution only applies if the options are reasonably certain to be exercised. Attribution between brother-sister groups owned by non-corporate owners is “reserved.” See Reg. §1.385-1(c)(4)(v).



Documentation & Maintenance Rules:

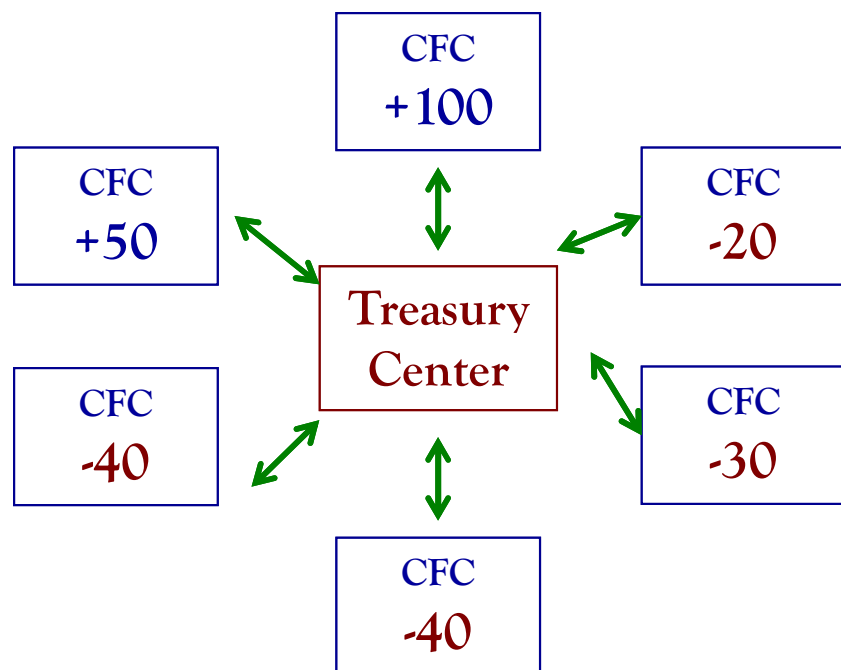
Reg. §1.385-2

1. **Documentations & Maintenance Requirements (Reg. §1.385-2(c)):** as of the timely filing of the covered member's tax return (with extensions), the covered member must have created written documentation evidencing the following:
 - Documentation** {
 - a. Binding obligation to repay;
 - b. Holder has creditor's rights to enforce the obligation
 - Ongoing Maintenance Requirements** {
 - c. Reasonable expectation of repayment (economic analysis)
 - d. Actions consistent with debtor-creditor relationship (debt repayment; written evidence of creditor actions upon a default).
2. **Threshold Requirements (Reg. 1.385-2(a)(3)(ii)):** Documentation requirements only apply if the stock of an any EG member (i) is traded on an established financial market (Reg. 1.1092(d)-1(b)), (ii) possesses total assets exceed \$100 million, or (iii) total revenue exceeds \$50 million
3. **Consequence.** Failure to satisfy any of these written documentation requirements as of tax return filing date or to provide this written information “upon request” results in the instrument being treated as stock **at the government's option**.
Exceptions (Reg. 1.385-2(b)): (i) **Rebuttable Presumption** for “highly compliant” taxpayers, (ii) **reasonable cause exception**, and (iii) exception for **ministerial omissions**. These are very complicated exceptions.
4. **Effective date:** Effective for instruments issued after December 31, 2017.

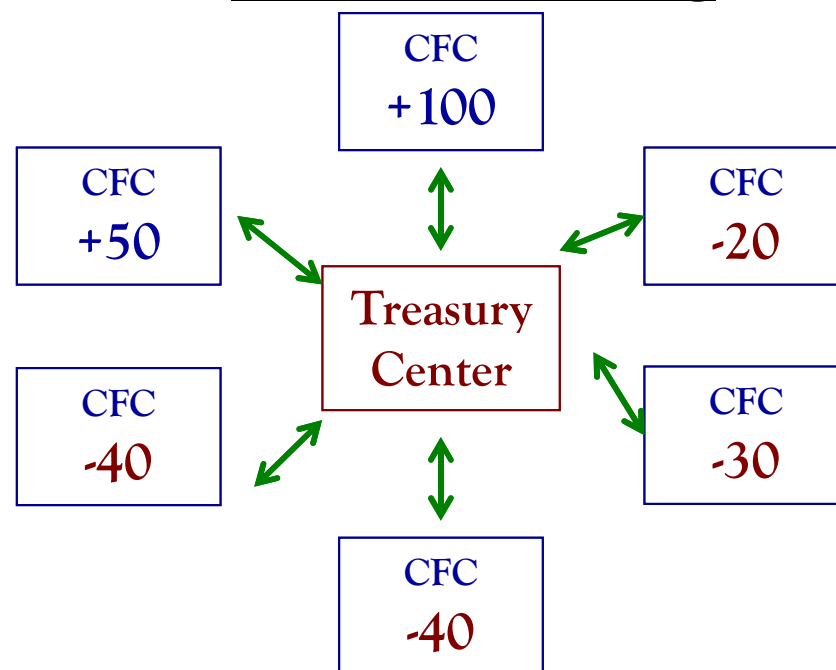


Documentation Requirements: Common Cash Pooling Arrangements Not Affected

ZBA Accounts



Notional Pooling



Documentation Requirements for these arrangements is substantially reduced and/or eliminated for any or all of the following reasons:

1. The final regulations “reserve” on whether to treat a foreign corporation as a “covered member,” so the existing regulations only apply to domestic corporations. Most cash pooling arrangements for US MNEs involve foreign affiliates only, not the US affiliate. See Reg. §1.385-1(c)(2) & -2(a)(3)(i).
2. The final regulations allow master agreements. See Reg. §1.385-2(c)(3)

1. Instruments issued within a US consolidated group are exempt. Reg. §1.385-4T(b)(1).



Documentation Requirements: Open Account / Evergreen Draw-downs

Example 1: CFC sells to US Affiliate on open account with 90 day terms as a regular practice. Must each sale that creates a trade payable meet the formal documentation requirement? Answer: Yes.

If each of the following were true: (i) the documentation and maintenance requirements of Reg. §1.385-2(c) were not met, (ii) the threshold specified in Reg. §1.385-2(a)(3)(ii) were exceeded, and (iii) none of the exceptions in Reg. §1.385-3(b) applied, then the US affiliate's payable is treated as an issuance of stock.



Documentation Requirements: Instrument Issued by DRE

Hypo: A disregarded entity is owned by a corporate member of an Expanded Group. The DRE fails the documentation requirement so that the instrument issued by the DRE is treated as stock.

Result: The final regulations treat the obligation of a disregarded entity that is owned by a corporate member of an expanded group as being stock of the corporate owner of the disregarded entity. See Reg. § 1.385-2(e)(4).

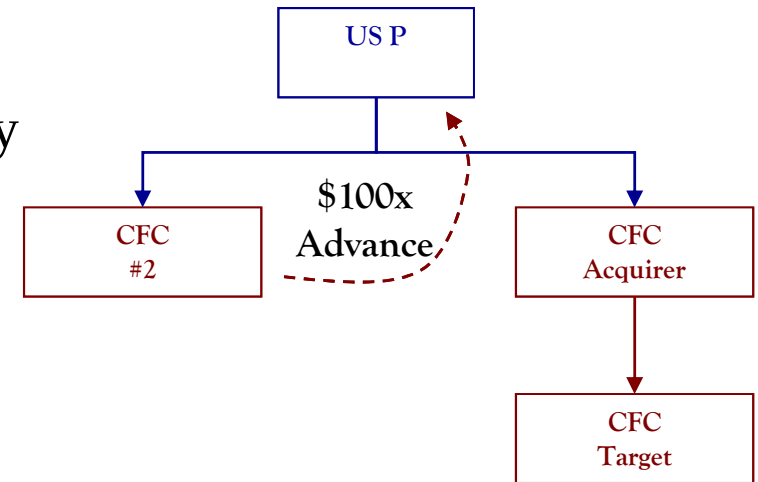
This outcome changes the result under the proposed regulations which would have caused the disregarded entity to become a partnership for tax purposes. [Preamble to TD. 9270, 83 Fed. Reg. at 72,872 and 72,926 - 72,927.



Section 956 Implications

Hypo: Assume a CFC advance to USP would have met the ordinary course exception under Section 956, but now the documentation requirement of 1.385-2 are failed. What is the result under Section 956?

Result: Under current law, this supplier advance avoids section 956 treatment if made in the ordinary course of purchasing goods from the US parent. See Reg. 1.956-2(b)(1)(a)(v). There is no similar exception within Reg. 1.385-2 for short-term trade payables. Moreover, there is no exception under §956 for instruments treated as stock. So, if the the documentation requirements of Reg. §1.385-2 are not met, then this trade payable becomes an issuance of US Parent's equity to its own CFC. As equity, no Section 956 exception would apply to prevent this equity investment by CFC from being an investment in US property.



Query whether USP's repayment of the trade advance is now a redemption tested under Section 302 that is likely a dividend from USP to CFC?



Documentation Requirements:

Further Comments on Final Regulations

1. Partial Compliance. The Rebuttable Presumption is a complex exception. The other exceptions are limited and may prove difficult to rely on in practice.
2. What will happen to instruments that do not meet the documentation requirements but are not in the form of debt but treated as debt (e.g., repos)? The final regulations reserve on this question for now.
3. What is the relevant date(s) for preparing documentation? Answer: by the time that the tax return is timely filed. However, ongoing maintenance requirements must be annually performed. And, if there were a credit event, then the exercise of creditor rights will need to be performed. Thus, although the final regulations are less onerous in comparison to the proposed regulations, there is still a significant ongoing maintenance requirement under the final regulations.
4. For demand debt, must credit worthiness be tested every day the debt is outstanding and documented daily? Answer: the final regulations suggest that demand debt must be tested annually.
5. Springing EGI's: consider documentation requirements for debt that was initially exempt or grandfathered, but now assume that a later corporate restructuring makes this debt subject to documentation, funding, and per se rules. See Reg. §1.1001-3.



Reg. Section 1.385-3

Per Se & Funding Rule

Per Se Rule (Reg. §1.385-3(b)(2)): An EGI is treated as stock (not debt) if issued in any of the following:

1. In a distribution described in Section 301 or Section 302(d)
2. In exchange for expanded group stock including “hook stock” issued by an EG member other than in an “exempt exchange;” or
3. In exchange for property in certain asset reorganizations among EG members.

Funding Rule (Reg. §1.385-3(b)(3)): A debt instrument issued with a principal purpose to fund a transaction covered by the Per Se Rule is subject to recast as stock.

Non-Rebuttable Presumption (Reg. §1.385-3(b)(3)(iii): A debt instrument is presumed to be issued with a principal purpose if issued 36 months before or after (72 month period) of one of the Per Se events.

Exceptions:

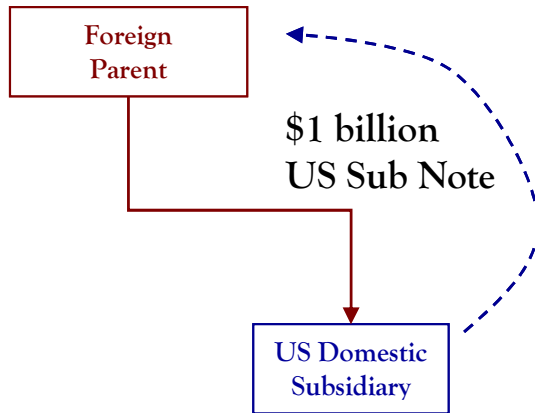
1. Debt issued by regulated banks and insurance companies
2. Exception for Qualified Short-Term Debt
3. Post-April 2016 Accumulated E&P Exception
4. Threshold (\$50 million) Exception (no longer a cliff effect)
5. Qualified Contribution Exception
6. Funded Acquisition Exception

Effective Date: EGI's issued on or after April 4, 2016 are subject to recast 90 days after final regulations issued (i.e., January 19, 2017).



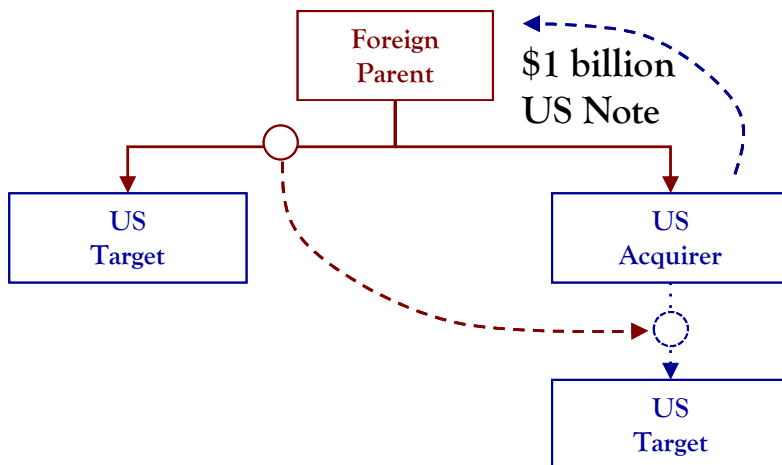
Per Se Rule Recast Results

§301 Distribution of Instrument*

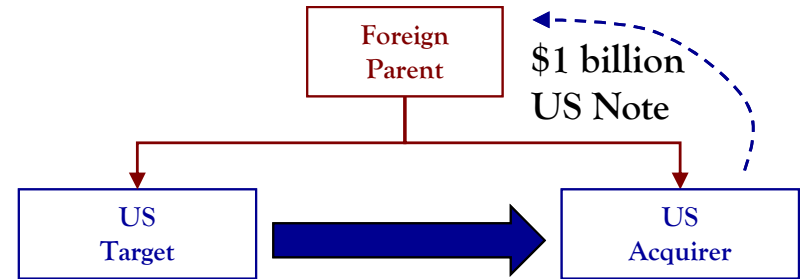


***Recast to §368(a)(1)(E)**

§304 with Boot (Recast to §368(a)(1)(E))



D Reorganization with Boot



***Recast to §368(a)(1)(D) with no boot**



Funding Rule:

Non-Rebuttable Presumption

Funding Rule: An EGI issued by a covered member that is not a “qualified short term indebtedness” is subject to being treated as stock if the EGI were issued with a principal purpose to fund a distribution or acquisition covered by the Per Se Rule.

Non-Rebuttable Presumption: A debt instrument is presumed to be issued with a tainted “principal purpose” if it is issued 36 months before or after one of the Per Se Rule events.

Hypothetical: Subsidiary distributes \$1,000 as a dividend in Year 0. In Year 2, Subsidiary has a new business opportunity and borrows \$1,000 from Parent to purchase a new company.

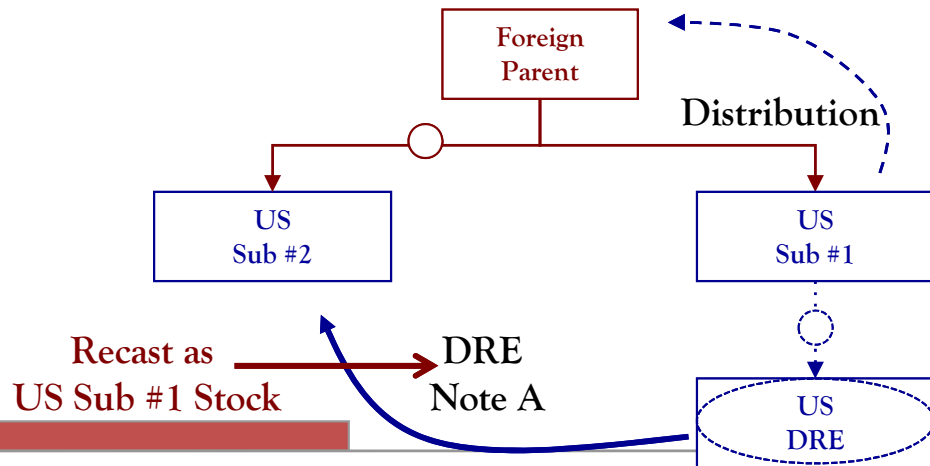
- *Funding Rule:**
- (1) Recast borrowing as nonvoting preferred stock.**
 - (2) Repayment is a distribution, not interest or principal repayment**
 - (3) Unless the ordinary course exception applies, a debt instrument issued within 36 months of a prohibited transaction is recast.**



Disregarded Entities

Rule: If an interest issued by a DRE is recharacterized as equity, it will be treated as stock in the covered member that owns the DRE. By treating the instrument as stock of the covered member and not as an equity interest in the DRE, the effect of this rule is to prevent the DRE from being recast into a partnership.

Hypothetical: US #2 lends funds to DRE in exchange for a DRE Note A. Within 36 months, US Sub #1 makes a distribution to Foreign Parent. If none of the plethora of exceptions applies, then the DRE Note A is recast as stock in US Sub #1 since the issuance of the DRE Note A was issued within 36 months before or after the US Sub #1 distribution.





Reg. Section 1.385-3

Exceptions

- Exceptions:**
1. Debt issued by banks, insurance companies, and security dealers
 2. Exception for Qualified Short-Term Debt
 3. Exception for Ordinary Course Loans
 4. Exception for Certain Interest-Free Loans
 5. Cash Pool Deposits
 6. Post-April 2016 Accumulated E&P Exception
 7. Threshold (\$50 million) Exception
 8. Equity Contribution Exception
 9. Funded Acquisition Exception
 10. Employee Stock Compensation Exception
 11. Exemption for deemed distributions by reason of section 482
 12. Exception to Prevent Cascading Re-characterization
 13. Exception for Distributions by reason of Liquidations and Spin-offs
 14. Exclusion of foreign issuers
 15. Exclusion of banks subject to regulation as a bank
 16. Exclusion of insurance companies regulated as an insurance company
 17. Refinancing grandfathered debt that existed before the effective date of the final regulations
 18. Exclude S Corporations, REITs and RICs



Major Take-Away Items

1. **Legal Inquiry Paradigm Shift.** Status of an instrument no longer depends on its legal terms and case law determination. Instead, the instrument is subject to recharacterization as nonvoting preferred stock if formal documentation and maintenance requirements are not met or if it is issued by a covered member in a transaction described in the “per se” rule or if it is issued by a covered member within 36 months of a per se transaction. Numerous exceptions now exist.
2. **Evergreen Analysis.** The status of an instrument can change over time. It may be a debt instrument in Year 1, but if a transaction described in Treas. Reg. 1.385-3 occurs within 36 months then it can be recast as nonvoting preferred stock at that point forward. So, analyzing an instrument at its date of issuance is no longer sufficient.
3. **Unlevel Playing Field.** The IRS can affirmatively invoke the recharacterization provisions of the Section 385 regulations, but the taxpayer cannot affirmatively use those same regulations to their own benefit. See Reg. §1.385-2(a)(5).
4. **Exceptions, Exceptions, and More Exceptions!!!!** The regulations require significant formal documentation and maintenance, but they only target three transactions of interest and then provide a myriad of exceptions. Existing inversion debt and base eroding structures are grandfathered. New interest-stripping transactions are allowed if the transaction avoids the three transactions of interest and meets the documentation and maintenance requirements or if one of numerous exceptions can be relied upon.



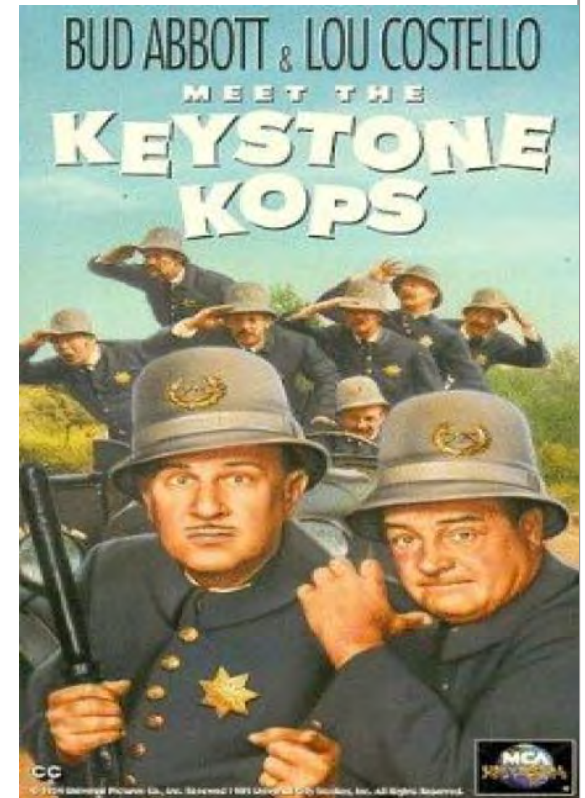
Path Taken, Path Not Taken, and Direction of Further Reform

1. **Path Not Taken: Section 385 Departs from Targeting Solely Inverted Companies**

81 FED. REG. 20,917: “For example, inverted groups and other foreign parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations.” I agree. See Bret Wells, *Corporate Inversions and Whack-a-Mole Tax Policy*, 143 Tax Notes 1429 (June 23, 2014).

2. **Path Taken: The final section 385 regulations adopt a cherry-picking approach.**

- **Question:** Do these final regulations represent merely a “tactical decision” that signals further evolution is going to occur along the lines outlined in the proposed regulations . . . but only incrementally? Or, are these regulations the end of the road?
- **Current Status:** These regulations create complexity that only tangentially addresses the broader earning stripping problem. The reality is that all cross-border debt, however created, creates an erosion of the tax base. A different approach would have been to holistically address base erosion arising from inbound interest-stripping transactions regardless of how the related party debt was created. See Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 Tax Law Rev. 535 (2012). The final regulations are a missed opportunity. By targeting only certain transactions and riddling these regulations with a plethora of exceptions, the regulations are likely to have only a limited impact and provide another area for fertile tax planning.



Questions?

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

Going In – International Structuring of Investment in Mexico Energy

November 3 & 4, 2016

John R. Cohn
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Thompson & Knight
ATTORNEYS AND COUNSELORS



Outline

- Mexico Energy: New Investment Opportunities
- Bilateral Investment Treaties
- Treaty Impact on Mexico Energy Investments
- Dutch Investment Structure (for now...)
- Tax Considerations under Mexican Law

Mexico Investments to Date - Summary

138

39

Individually Consortiums

30



**Awarded
Contracts**



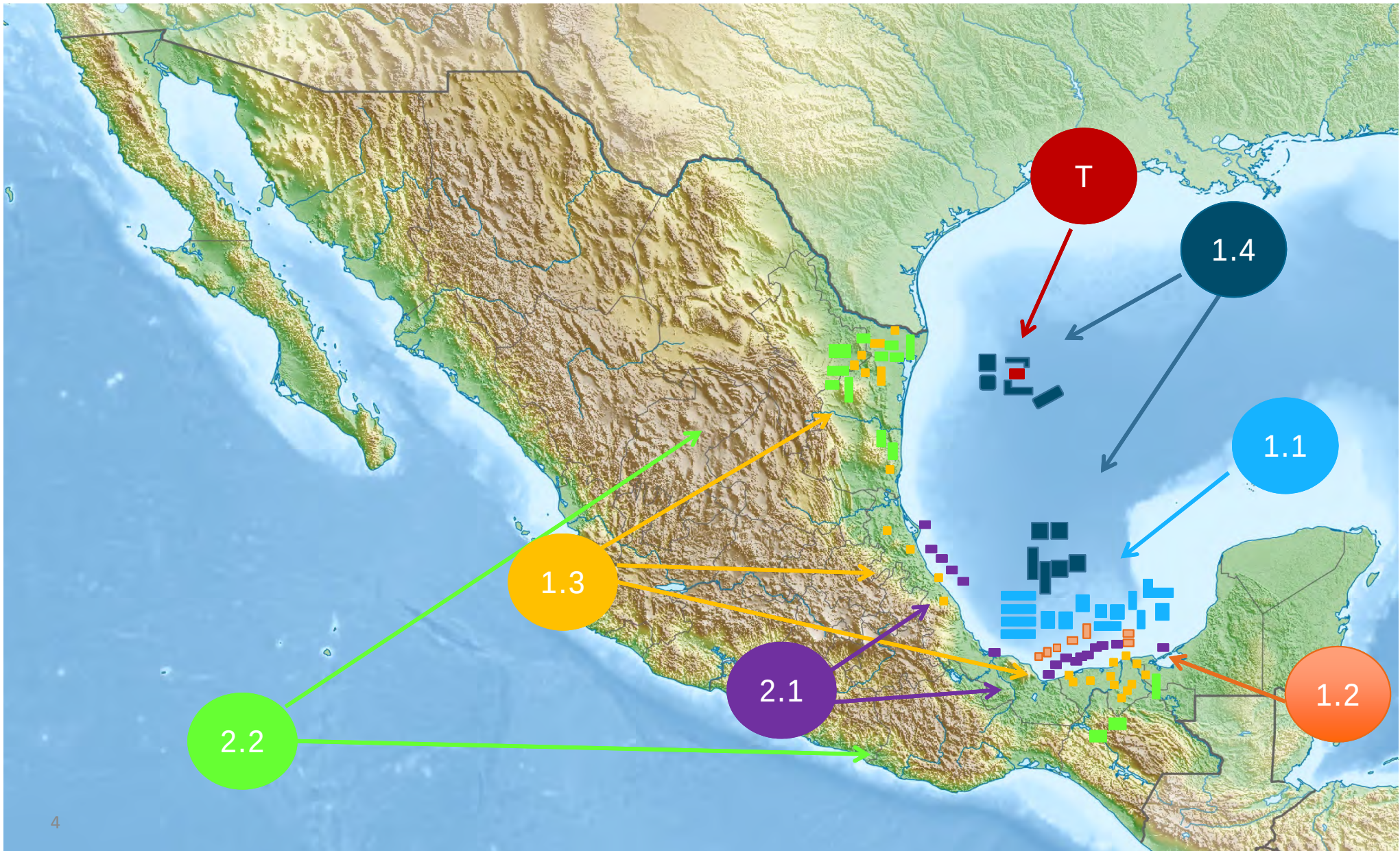
**No. of Prequalified
Companies**

40



**Awarded
Companies**

Round 1 & 2 - Map



	R. 1.4	R. 2.1	R. 2.2	Trion
Contract Areas	10 Deepwater	15 Shallow Waters	12 Onshore	1 Deepwater
Contract Type	License	Production Sharing Contract	License	License
Prequalified Companies	26	--	--	--
Decision Date	December 5, 2016	March 22, 2017	April 5, 2017	December 5, 2016
Economic Proposal	Additional Royalty / Increase in the minimum work program (0,1,1.5)	Gov. Share of Profit / Increase in the minimum work program (0,1,1.5)	Additional Royalty / Increase in the minimum work program (0,1,1.5)	Additional Royalty for the State (<u>3-4%</u>)
No. of Interested Companies	26 (Prequalified)	4 (Have Shown Interest)	No information provided yet	10 (May begin prequal process)

Foreign Investment Protection

- Foreign direct investment advances development and leverages the growth of economies.
- To promote investment, countries have entered into bilateral treaties (BITs) to promote and protect foreign investment.
- There are currently 2,953 signed BITs, of which 2,322 are in force as of August 25, 2016.
- Direct and indirect protection.

Bilateral Investment Treaties

- Scope and definition of investment
- Admission and establishment
- National treatment
- Most-favored-nation treatment
- Fair and equitable treatment
- Compensation in the event of expropriation or damage to the investment
- Guarantees of free transfers of funds
- Dispute settlement mechanisms, both state-state and investor-state

Mexico BITs – 30 in Force

- Argentina
- Australia
- Austria
- Bahrain
- Belarus
- BLEU (Belgium-Luxembourg Economic Union)
- China
- Cuba
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Greece
- Iceland
- India
- Italy
- Korea, Republic of
- Kuwait
- Netherlands
- Panama
- Portugal
- Singapore
- Slovakia
- Spain
- Sweden
- Switzerland
- Trinidad & Tobago
- United Kingdom
- Uruguay

Where are the United States and Canada?

- Article 11 (Investment) of the North America Free Trade Agreement provides provisions similar to other BITs.
- NOTE:
 - In 1994, Mexico had reserved the right to restrict any investments by investors of the U.S. and Canada in petroleum, hydrocarbons and basic petrochemicals
 - At that time, the Mexico Constitution barred such investments
 - Thus, some clarity is needed as to how Mexico will treat its reservations under NAFTA in light of the amendment to the Mexican Constitution

BITs and Structuring

- Stacking - direct or indirect investments

- › Switzerland-Mexico BIT, art. 1(4):

Investment of an investor of a Party means an investment that is owned or controlled, **directly or indirectly**, by an investor of such a Party

- Limitations

- › Direct investment

- U.K.-Mexico BIT – Investor is a national or entity of one Contracting Party “who has made an investment in the territory of the other Contracting Party”.

- › Substantiality

- Australia-Mexico BIT – “Investor of a Contracting Party” means “an enterprise of a Contracting Party that has substantive business operations in the territory of the Contracting Party under whose laws it is constituted or organised”.

Tax Treaties

- Avoid or minimize double taxation
- Provide credits or exemptions
- Raise threshold on incidence of tax
- Reduction of withholding tax rates on cross-border payments
- Exemption or reduction of tax rates on capital gains
- Unlike BITs, generally only direct investment benefits

Mexico Tax Treaties – Over 50 in Force

- **Australia**
- **Austria**
- **Bahrain**
- Barbados
- **Belgium**
- Brazil
- **Canada**
- Chile
- **China**
- Colombia
- **Czech Republic**
- **Denmark**
- Ecuador
- Estonia
- **Finland**
- **France**
- **Germany**
- **Greece**
- Hong Kong
- Hungary
- **Iceland**
- **India**
- Indonesia
- Ireland
- Israel
- **Italy**
- Japan
- **Korea, Republic of**
- **Kuwait**
- Latvia
- Lithuania
- **Luxembourg**
- Malta
- **Netherlands**
- New Zealand
- Norway
- **Panama**
- Peru
- Poland
- **Portugal**
- Qatar
- Romania
- Russian Federation
- **Singapore**
- **Slovakia**
- South Africa
- **Spain**
- **Sweden**
- **Switzerland**
- Turkey
- Ukraine
- U.A.E.
- **United Kingdom**
- **United States**
- **Uruguay**

Importance for Mexico Energy Investments

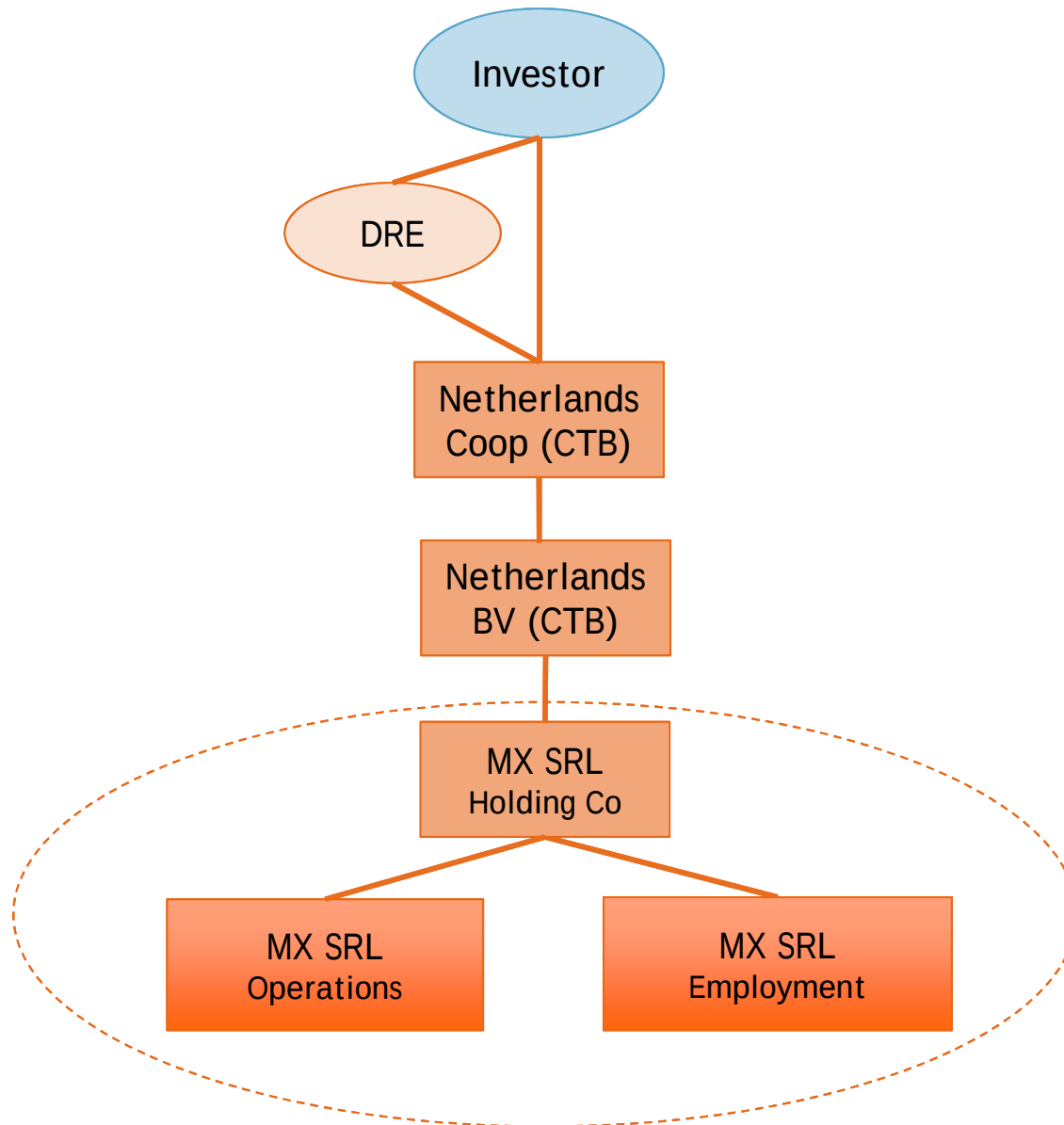
○ Dividends

- › Mexican law: 10% withholding tax on dividend distributions made by Mexican companies
- › Treaties: may reduce rate to 5% or 0%

○ Exit strategies

- › Mexican law: 35% capital gains tax on sales of shares by nonresidents
- › Treaties:
 - Limited exemption: US – 0% if <25% ownership
 - Limited rate: Netherlands – 10%

Dutch Investment Structure . . . for now



Mexico - Tax Rate & Integrated Tax Regime

- 30% on net taxable income.
- As of 2014, Mexico's tax consolidation system has been replaced by a new integrated regime, allowing groups to combine results on an annual basis.
 - The benefits are subject to recapture after three years.
- In order to qualify for this regime:
 - A foreign parent must own its Mexican operating companies through a Mexican holding company that owns more than 80% of their voting shares.
 - Authorization must be requested prior to August 15 the year before the integrated return will be filed.

Depreciation

- All types of fixed assets, both tangible and intangible, are depreciable for tax purposes under Mexican tax law.
- Depreciation is calculated using the straight-line method
 - › Commences the month the asset was purchased
 - › No allowance for estimated disposal values

Depreciation (Cont.)

The basic depreciation rates are as follows:

Assets	Depreciation Rates
Outlays prior to commencing operations	10%
Industrial buildings and warehouses	5%
Machinery and equipment	10%
Furniture and fixtures	10%
Cars, vans and trucks	25%
Leasehold improvements	Lease terms
Environmentally-friendly machinery and equipment	100%
Intangible asset with an indefinite life	5%
Intangible asset with a definite life	15%

Mandatory Profit Sharing

- Employers must share 10% of their profits with employees
- To mitigate this requirement, companies set up two separate entities in Mexico:
 - › An entity to run the business with limited employees
 - › An entity to hire and lease out employees to the business

International Tax Developments
(other than Section 385 and BEPS)
by Adam S. Halpern
Fenwick & West LLP

Texas Bar Association Presentation
Dallas: Nov. 3, 2016
Houston: Nov. 4, 2016

- I. *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), on appeal to 9th Circuit. 2003 regulation requiring stock-based compensation to be cost-shared held invalid; Treasury and IRS failed to engage in “reasoned decisionmaking” as required under Administrative Procedures Act and *Motor Vehicles Mfrs. Ass’n v. State Farm*, 463 U.S. 29 (1983).
- II. Order in *Eaton Corp. v. Commissioner*, Tax Court Docket No. 5576-12 (Apr. 6, 2015). Privilege waived by asserting reasonable cause defense to transfer pricing penalty; taxpayer ordered to produce documents or have reasonable cause defense portions of petition stricken; no appeal possible.
- III. *Guidant LLC v. Commissioner*, 146 T.C. 60 (2016). Taxpayer’s motion for summary judgment denied; whether IRS failure to specify separate company § 482 adjustments was arbitrary, and whether aggregation was most reliable means of determining arm’s length consideration were both issues of fact for trial.
- IV. *Medtronic, Inc. v. Commissioner*, 111 T.C.M. (CCH) 1115 (2016). Puerto Rican restructuring; Tax Court rejected IRS argument to “aggregate” transactions and treat Puerto Rican manufacturer as cost-plus entity; taxpayer’s CUT method, with adjustments, accepted as providing most reliable means of determining arm’s length result; court also rejected application of Section 367(d).
- V. 2016 APA Report, Ann. 2016-12, 2016-16 I.R.B. 1. APA statistics for 2015 year.
- VI. Final Section 956 / Partnership Regulations, T.D. 9792 (Nov. 2, 2016). Final regulations apply aggregate theory of partnerships for various purposes under § 956; 28-year temporary anti-avoidance rule finalized.

VII. Notice 2015-54, 2015-34 I.R.B. 210. New gain deferral method must be used to preserve tax-free § 721 contribution by U.S. person to partnership with related foreign partner.

VIII. Proposed Section 367(d) Regulations, REG-139483-13, 2015-40 I.R.B. 475. Elimination of active foreign business exception for outbound transfers of foreign goodwill and going concern value.

IX. Apple EC State Aid Decision. European Commission rules Ireland must collect €13B from Apple, representing 10 years of back taxes.

X. Notice 2016-52, 2016-40 I.R.B. 425. New foreign tax credit splitter for certain foreign-initiated adjustments in excess of \$10 million.

XI. *Vento v. Commissioner*, 147 T.C. ____ (2016). Sisters who paid tax to Virgin Islands as bona fide residents failed to exhaust all practical and effective remedies to reduce foreign tax liability; foreign tax credits denied.

XII. Proposed Reporting Regulations for Foreign-Owned Domestic Disregarded Entities.

XIII. Proposed Withholding Regulations on Section 305(c) Deemed Distributions.

XIV. New U.S. Model Treaty.

XV. *Eshel v. Commissioner*, 831 F.2d 512 (D.C. Cir. 2016). Tax Court applied wrong standard for determining proper interpretation of treaty provision; U.S. dictionary definitions did not reflect shared intentions of contracting states; reversed and remanded.

XVI. Anti-Inversion Regulations and Lawsuit with Respect Thereto. U.S. Chamber of Commerce and Texas Association of Business challenge April 2016 multiple domestic acquisition rule, widely believed to be responsible for Pfizer terminating its intended acquisition of Allergan.

Summary of Section 956 Final Regulations

-- The anti-avoidance temp. reg. is now a final reg. The final rule treats a CFC as holding US property held by a related foreign corporation if a principal purpose of creating, organizing or funding by any means (including through capital contributions or debt) the related foreign corporation is the avoidance of Section 956 with respect to the CFC. Treasury and the IRS declined to narrow the scope of "funding" but provided some new examples to illustrate that ordinary business transactions are not meant to be caught up in the rule. The rule also now extends to investments in US property made indirectly through related partnerships created, organized or funded with a bad purpose. These rules apply to US property investments acquired (or deemed acquired in a Treas. Reg. sec. 1.1001-3 exchange) on or after Sept. 1, 2015.

-- The T.D. obsoletes and withdraws Rev. Rul. 90-112. The revenue ruling limited a CFC partner's investment in US property held through a partnership to the CFC's outside basis in its partnership interest. Treasury and the IRS stated that the outside basis limitation is inconsistent with the aggregate approach to partnerships adopted in the final regs. Thus, new Treas. Reg. sec. 1.956-4(b) provides that the amount of a CFC partner's investment in US property held through a partnership is the CFC's "attributable share" of the partnership's adjusted basis in the US property. The CFC's attributable share is based on its liquidation value percentage, taking into account any special allocations of book income or gain with respect to particular partnership property, subject to an anti-avoidance exception. These rules apply to US property investments acquired (or deemed acquired) on or after Nov. 3, 2016. However, Treasury and the IRS also published proposed regulations yesterday proposing to eliminate the special allocations rule. Under these newly proposed regulations, a CFC's attributable share of a partnership's US property would be based solely on liquidation value percentage, without regard to special allocations.

-- As under the proposed rules, the final rules treat a partner in a foreign partnership as being the debtor on its attributable share of any loan on which the partnership is the debtor. Thus, a loan from a CFC to a foreign partnership can create a Section 956 issue if the partnership has a US partner related to the CFC. The US partner's "attributable share" is also based on liquidation value percentage (a change from the proposed rules). The CFC's investment in US property can be increased beyond the related US partner's attributable share to the extent the partnership makes a distribution to the related US partner that it would not have made but for the CFC loan. This rule only applies to CFC loans to foreign partnerships; a CFC's loan to a related US partnership is a loan to a related US person and thus an investment in US property without regard to the new rule. These rules apply to US property investments acquired (or deemed acquired) on or after Nov. 3, 2016.

-- As under the proposed rules, the final rules extend the Section 956 guarantee rule to partnerships. They treat a partnership as holding an obligation of a US person to the extent it is the pledgor or guarantor of the obligation. A CFC partner is then treated as holding its share of the obligation under the rule mentioned in the second paragraph above. These rules apply to US property investments acquired (or deemed acquired) on or after Nov. 3, 2016. The final rules do not address the "multiple inclusions" issue when multiple CFCs or partnerships act as guarantors or pledgors supporting the same obligation.

-- As under the proposed rules, the final rules treat an obligation of a disregarded entity as an obligation of its single owner for Section 956 purposes. This rule applies retroactively, to US property investments acquired (or deemed acquired) on or after Sept. 1, 2015.

Transfer Pricing 2016 Update Transcript Notes

LB&I Re-organization, Selection of Cases, Country-by-Country Reporting, and MAP procedures

Texas State Bar Tax Section International Tax Update 2016
November 3 in Dallas / November 4 in Houston

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Abstract: Transfer pricing is the hottest audit topic of tax risk managers today. Overlapping compliance with U.S. I.R.C. Section 482 and foreign countries' transfer pricing rules is an inescapable part of doing business internationally. The OECD enabled collaborative effort against Base Erosion and Profit Shifting (BEPS), with participation by the revenue departments from developed, emerging, and lesser developed countries, has raised the bar considerably in each country wherein a company has business interests. The OECD Transfer Pricing Guidelines have been substantially amended. Country-by-country reporting (CbCR) in an audit-friendly, standardized format of related party transactions, alongside a group's global and local economic indicators, is the new norm.

Going forward, approximately 8,000 multinational corporations will provide both a global tax file and a local tax file to each national revenue department for a country within which it transacts business. Such robust information will empower, and probably encourage, each revenue department to source a portion of a corporation's group tax base within its taxing jurisdiction. Corporate tax counsel have expressed concern that, as each country 'claims its piece of the pie', taxation will reduce profits beyond an acceptable investment return. At a minimum, the coming years will include growing number of audits around the world, and require beefing up the tax risk management department and corporate transfer pricing team.

Prof. William Byrnes, primary author of [Lexis Practical Guide to U.S. Transfer Pricing](#), will provide the 2016 update for transfer pricing and its new compliance burdens brought about by the OECD 'BEPS' project. [Lexis Practical Guide to U.S. Transfer Pricing](#) is an in-depth treatise of analysis designed to help multinationals cope with the transfer pricing rules and procedures, taking into account the international norms established by the Organization for Economic Co-operation and Development (OECD).

In the nineties, Professor William Byrnes held a senior international tax position as a transfer pricing expert with a Big Six accounting firm. Since then he has authored and co-authored eight Lexis tax and compliance treatises, a 10-volume Kluwer compendium, 16 chapters of Mertens Federal Income Taxation and three National Underwriter Tax Facts books. Texas A&M University law faculty will launch a risk management online executive graduate program January 2017 that will eventually include transfer pricing courses.

1. 2015 – 2016 Restructure of Large Business and International (LB&I)

1.1 Resource depletion

Over the past two years, the IRS Large Business and International division has experienced a wrath of resignations of its executive level ranks. Several potential causes of these resignations stand out, such as the lack of Congressional budget support, the recent reorganization of LB&I, and the lure of big firm salaries. By example of six of these executive resignations, LB&I has lost:

- The Transfer Pricing Director Sam Maruca who joined Covington & Burling, and
- His successor David Varley who joined Deloitte,
- The Deputy Commissioner of International Michael Danilack who joined PwC,
- The Director of International Strategy Diana Wollman who joined Cleary Gottlieb,
- The Director of the Advance Pricing and Mutual Agreement (APMA) program Richard McAlonan who joined E&Y, and
- The Deputy Commissioner Domestic Laura Prendergast who also joined E&Y.

On July 3, 2014 Douglas O'Donnell, LB&I assistant deputy commissioner, replaced Michael Danilack as Deputy Commissioner, with permanency in December 2014. However, a year later on July 15, 2015 Douglas O'Donnell was promoted to Commissioner of LB&I. Douglas O'Donnell has 30 years' experience with the Service, and managed the process of developing and implementing the exchange of information system required for FATCA. David Horton was named his replacement as Acting Deputy Commissioner on July 12, 2015, while also serving in acting capacity as the U.S. Competent Authority. David Horton also has over 30 years of IRS experience, including one of the leads for developing the TPO. David Horton has since moved into the position of Assistant Deputy Commissioner Compliance Integration. Theodore Setzer has moved into the role of Assistant Deputy Commissioner (International), bringing with him over a decade of tax treaty and information exchange experience.

Hareesh Dhawale, as the Acting Director of APMA, replaced Richard McAlonan, his appointment since has been made permanent. Hareesh Dhawale resigned on July 9, 2016 and has been replaced by John Hughes as the acting director. In January 2015, Donna McComber was promoted from an APMA senior manager economist to Acting Deputy Director of the APMA Program, her appointment now also permanent as Assistant Director. As the APMA Assistant Director, Donna McComber focuses on quality control measures and is engaged in evaluating proposed settlements for all significant APA and MAP cases.

In June of 2015, in light of its budget constraints and decreasing personnel, LB&I revealed that it would reorganize its examination process and protocols.¹ As of June 2015 LB&I's staffing has been reduced from 5,500 from a high of 7,500 in 2010. Of the 5,500 LB&I positions, between 500 and 600, it is reported, are international trained examiners in addition to 2,800 domestically trained.² Although the IRS reports that 80 percent of the issues, by revenue, are international in nature, only 20 percent of the resources are allocated to these issues. For fiscal year 2017, the IRS has requested \$13,244,992,000 to support IRS activities for FY 2017 which represents a \$530,347,000 increase over its 2016 fiscal year enacted level of \$11,235,000,000.³

1.2 Impact: 2015/2016 Organization Restructure

Based on a long term prognosis of its budget and resources, in 2016 the IRS begun a new reorganization, albeit more of an evolution of the 2015 restructure (the "2016 Reorganization"). The enforcement efforts in the transfer pricing area will be dramatically centralized and, in part, be centered around issue based

¹ Varley: *LB&I Plans to Reorganize Examiners into Practice Areas, Seeks to Expand APMA*, 24 Transfer Pricing Rep (BNA Tax Mgmt) (July 10, 2015). See IRS Budget in Brief, FY2017. Available at <https://www.irs.gov/PUP/newsroom/IRS%20FY%202017%20BIB.pdf> (last visited Oct. 1, 2016).

² *Budget Cuts Forcing 'Re-Engineering' of International Audits, IRS Official Says*, 23 Transfer Pricing Rep (BNA Tax Mgmt) (Feb 27, 2015).

³ Budget in Brief FY 2017, See Available at <https://www.irs.gov/PUP/newsroom/IRS%20FY%202017%20BIB.pdf> (last visited Oct. 1, 2016).

campaigns.⁴ The restructuring *eliminated* the position of Deputy Commissioner (International), the position that was formerly delegated the power to act as the Competent Authority under tax treaties. Although a new delegation order has not been released, LB&I Commissioner Doug O'Donnell reported that the new delegation will likely run through the LB&I Commissioner and Deputy Commissioner to the specific practice areas where the delegated authority is exercised, the Advance Pricing and Mutual Agreement Program and the Treaty Assistance Interpretation Team.⁵

In the past, LB&I functions were split into international and domestic divisions. Under the new structure, there is no longer such a divide; each of the new practice areas report to a single deputy commissioner. A Director of Program and Business Solutions, an Assistant Deputy Commissioner of Compliance Integration, and the Assistant Deputy Commissioner International also report to the single Deputy Commissioner. LB&I has shifted its employees into “practice areas” of employees focused on specific compliance areas in order to leverage knowledge-sharing capabilities. LB&I is organized into Support and Practice Areas. Support elements use data analysis and an integrated feedback loop to support LB&I's agile model. The Practice Areas study compliance issues within their area of expertise and suggest campaigns to be included in the compliance plan.⁶

Headquarters and Support

- Assistant Deputy Commissioner, Compliance Integration
- Assistant Deputy Commissioner, International
- Program and Business Solutions

Practice Areas

- Cross Border Activities Practice Area
- Enterprise Activity Practice Area
- Pass Through Entities Practice Area
- Treaty and Transfer Pricing Operations Practice Area
- Withholding and International Individual Compliance Practice Area

Compliance Practice Areas

- Central Compliance Practice Area
- Eastern Compliance Practice Area
- Northeastern Compliance Practice Area
- Western Compliance Practice Area

Each practice area is led by a Director.⁷ Three of the five practice areas under the new Commissioner for LB&I structure directly relate to international compliance: Cross Border Activities, Treaty & Transfer Pricing Operations, and Withholding & International Individual Compliance. Reporting to these

⁴ Former IRS Official Varley Advises Taxpayers On Adjusting to New LB&I Structure, Shift to ‘Campaigns,’ 24 Transfer Pricing Rep. (BNA Tax Mgmt.) 1336 (Mar. 3, 2016).

⁵ Dolores Gregory, *LB&I to Focus on Audit Approach, Cultural Shift in 2016*, 24 Transfer Pricing Rep. (BNA Tax Mgmt.) 1074 (Jan. 7, 2016); IRM § 1.4.43.12 (Jul. 1, 2010).

⁶ LB&I AT-a-Glance. Available at <https://www.irs.gov/businesses/international-businesses/large-business-and-international-division-at-a-glance> (Aug 1, 2016).

⁷ See Today's IRS Organization. Available at <https://www.irs.gov/uac/todays-irs-organization> (last visited Aug 1, 2016).

Directors are the Territory and Program Managers, to whom Team Managers with multiple case assignments report.⁸ A campaign driven audit may include a geographical area and a compliance practice area.

For examination purposes, the IRS is divided into four operating divisions of which the LB&I is the one with jurisdiction over virtually all transfer pricing audits. The renamed Treaty & Transfer Pricing Operations is the compliance organization within LB&I responsible for transfer pricing issues. It is led by the Director of the renamed Treaty & Transfer Pricing Operations, Sharon Porter, who is responsible for transfer pricing activity in the field and for allocating specialists and other resources to the most important transfer pricing cases. Under the Director of Treaty & Transfer Pricing Operations are a Director of Field Operations for the Transfer Pricing Practice (TPP), Cheryl Teifer, a Director of the Advance Pricing and Mutual Agreement Program (APMA), John Hughes, and a Director of Treaty Administration, Jennifer Best.

1.3 Impact: New Risk Based Campaigns Audit Strategy

In the 2016 Reorganization, LB&I's TPP has retained autonomy and can be expected to garner more authority over audit issues that are identified for a campaign and perhaps more authority generally in the audit of transfer pricing. The 2016 new audit strategy will be designed around campaigns. The campaigns will be built around centralized compliance plans focused on areas of strategic interest.⁹ The divisions will identify campaign issues and then allocate divisional resources among the campaigns. The campaign may focus on initiating audits or instead focus on issuing guidance.¹⁰ Thus, examiners in the field will no longer be able to pursue a new issue for audit without receiving permission.

Consequently, the IRS is shifting tact from its Coordinated Industry Case (CIC) model with continuous auditing to risk assessment modeling. LB&I Commissioner Douglas O'Donnell stated in spring 2015 that these coordinated audit groups are leveraging the risk based approach by weighing the size of the compliance risk, how often the risk is occurring, where it is occurring and if the risk is a result of a promoted scheme.¹¹ The measurement of performance may shift from the number of case closures to number of case openings and time expended on each case. LB&I will follow the lead of the Treaty and Transfer Pricing Practice as a practice area group and develop other ones, as well as reconstitute exam teams along specialized practice areas.

The IRS released "principles of collaboration" that encourage greater and more transparent interaction among taxpayers, examiners, and LB&I leadership.¹² The principles of collaboration encourage consultation with subject matter experts and counsel as well as consistent treatment of similarly situated taxpayers and cases. These operational changes may take two to four years to complete with the IRM undergoing further amendment as the initiatives progress.

⁸ See LB&I Directory. Available at <https://www.irs.gov/businesses/large-business-and-international-lb-i-division-directory> (last visited Aug 1, 2016).

⁹ *Former IRS Official Varley Advises Taxpayers On Adjusting to New LB&I Structure, Shift to 'Campaigns,'* 24 Transfer Pricing Rep. (BNA Tax Mgmt.) 1336 (Mar. 3, 2016).

¹⁰ Dolores Gregory, *LB&I to Focus on Audit Approach, Cultural Shift in 2016*, 24 Transfer Pricing Rep. (BNA Tax Mgmt.) 1074 (Jan. 7, 2016).

¹¹ *Limited Resources Driving IRS to End CIC Program, Move to Risk-Based Audits*, 24 Transfer Pricing Rep. (BNA Tax Mgmt.) (June 11, 2015).

¹² IRM §4.46.1.4 (Mar. 9, 2016). Available at https://www.irs.gov/irm/part4/irm_04-046-001.html (last visited Oct. 1, 2016).

1.4 Impact: Freeze Compliance Assurance Program (CAP)

The IRS' Compliance Assurance Program (CAP) began as a pilot program in 2005 with 17 taxpayers and has grown to include 181 taxpayers today. In 2011, the CAP program became permanent and added the Pre-CAP and Compliance Maintenance phases. The rest of the program has remained relatively unchanged since its inception. However, in 2016 the IRS announced that it is reconsidering the CAP program.¹³ The IRS has indicated that because of resource constraints and the limited benefits of CAP in achieving compliance it may curtail the process. LB&I is in the process of assessing all three phases of the Compliance Assurance Process (CAP) program. The three phases are CAP, Pre-CAP and Compliance Maintenance. The assessment will include input from both internal and external stakeholders to determine if any changes are needed to the program. No new taxpayers will be accepted into the CAP program for the 2017 application season that began September 2016.

In 2014, approximately 1,000 transfer pricing disclosures of uncertain tax positions on the Schedule UTP were reported, slightly down from the previous three years. Note that in 2014 the Schedule UTP filing threshold was reduced from an initial \$100 million to \$50 million to the current corporate taxpayers with \$10 million and more in assets, and that record a reserve for UTP in their audited financial statements.

2. OECD BEPS/TPG Update and Its Impact on US Clients

On May 23, 2016 the OECD Council formally approved amendments to its Transfer Pricing Guidelines to incorporate the BEPS transfer pricing measures. All countries that participated in the OECD/G20 BEPS Project, including the U.S., agreed to the amendments. The amendments introduced in the Transfer Pricing Guidelines currently impact six of its nine chapters of the Guidelines. Expect more amendments in 2017.

Chapter I, Section D addressing factors for determination of arm's length is deleted and replaced by new guidance. The new guidance includes eight areas:

1. Identifying the commercial or financial relations (e.g. contractual terms, functional analysis, risk, property or services, economic circumstances, and business strategies).
2. Recognition of the accurately delineated transaction.
3. Losses.
4. The effect of government policies.
5. Use of customs valuations.
6. Location savings and other local market features.
7. Assembled workforce.
8. MNE group synergies.

Incorporated into the OECD Transfer Pricing Guidelines is a value chain analysis (VCA) framework. The value chain analysis requires a description of the internal processes through which the company designs, produces, sells, delivers and supports its products. A value chain analysis requires organizing an enterprise into strategically important segments and activities and then assessing the impact of each segment and activity on the company's costs and its behaviour.

¹³ IRS Continues Comprehensive Assessment of the CAP Program (Aug. 26, 2016), <https://www.irs.gov/businesses/corporations/irs-continues-comprehensive-assessment-of-the-cap-program> (last visited Oct. 1, 2016).

Chapter II addressing transfer pricing methods has a new paragraph inserted following paragraph 2.9 and new paragraphs are added following paragraph 2.16 that address the application of the CUP method in the context of commodity transactions).

The current provisions of Chapter V addressing documentation are deleted in their entirety and replaced by new guidance and annexes setting forth a three tier standardized approach to transfer pricing documents and country-by-country reporting. The current provisions of Chapter VI addressing intangibles and its annex are deleted in their entirety and replaced by new guidance and a new annex. The current provisions of Chapter VII addressing intra-group services are deleted in their entirety and replaced by new guidance. The current provisions of Chapter VIII addressing cost contribution arrangements are deleted in their entirety and replaced by new guidance. At the time of this CLE for the Texas State Bar, work remains to be completed to amend the remainder of the Transfer Pricing Guidelines. The OECD's WP6 is currently working on amending the Transfer Pricing Guidelines Chapter IX Transfer Pricing Aspects of Business Restructurings. According to OECD, with a goal for completion before 2017 the revised content of Chapter IX will be integrated into the Transfer Pricing Guidelines.

3. Country by Country Reporting (CbCR) and MAP

3.1 CbCR

From this year, overlapping compliance of U.S. Section 482 reporting requirements with those of foreign countries' transfer pricing rules is an inescapable part of doing business internationally. The OECD's collaborative effort against Base Erosion and Profit Shifting, known by its acronym BEPS, has expanded to include the participation of the revenue departments of over 100 countries has raised the bar considerably in each country wherein a company has business interests.

The OECD Transfer Pricing Guidelines have been substantially amended. Country-by-country reporting (CbCR) in an audit-friendly, standardized format of related party transactions, alongside a group's global and local economic indicators, is the new norm. It is expected that the 47 countries that have agreed to automatically exchange transfer pricing country-by-country reports will grow to the level of 106 countries that have already signed the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters that requires the automatic exchange the tax and financial information of individuals.

On October 5, 2015 the OECD released its 2015 Final Report Country-by-Country Reporting Action 13. The CbCR Final Report comprised a three tier standardized approach, each tier designed to reveal distinct functions and risks of a group's entities. The OECD Council amendments to Section V of its Transfer Pricing Guidelines include:

- A master file of the MNE's transfer pricing documentation that provides tax administrations with high-level information regarding the MNE's global business operations and transfer pricing policies, made available to all relevant tax administrations that have jurisdiction over a group member of an MNE.
- A local file that provides a granular transfer pricing analysis requiring that detailed transactional transfer pricing documentation specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.
- A Country-by-Country report (CbCR) containing revised standards for transfer pricing documentation and a template for country-by-country annual reporting of profit before income tax, income tax paid and accrued, and certain measures of economic activity.

The CbCR, for this initial stage at least, applies only to large MNEs. CbCR also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

The CbCR requirements are to be implemented for fiscal years beginning on or after January 1, 2016 and apply, subject to a 2020 review, to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million.

On March 22, 2016 the OECD released its standardized electronic format for the exchange of Country-by-Country (CbC) Reports between jurisdictions (“CbC XML Schema”) and an accompanying CbC XML Schema User Guide (“CbC XML Guide”). The CbC XML Guide reiterates the information required to be included in each data element of the CbC Report, and guidance on how to make corrections of data. CbC Reports in the CbC XML Schema will be electronically transmitted between Competent Authorities. Thus, tax administrations will annually receive key information on the global allocation of income and taxes paid, together with other indicators of the location of economic activity within the MNE group. From a local file perspective, the key information will include which entities do business in the jurisdiction and the business activities each entity engages in. The CbC Reports covering the 2016 year will first

On December 23, 2015 the U.S. Treasury issued proposed regulation REG-109822-15. On June 29, 2016, consistent with the proposed regulations and the OECD’s Action 13 Final Report, the Treasury released the final regulations requiring that annual country by country reporting by certain U.S. persons that are the ultimate parent entity of a multinational enterprise group. The final regulations (TD 9773) affect a U.S. person that is the ultimate parent entity of a multinational enterprise group with annual revenue for the preceding annual accounting period of at least \$850 million. The regulations are effective from June 30, 2016 although the regulations allow a U.S. person to voluntarily file a CbCR that includes the time period from January 1, 2016 in order to avoid a CbCR compliance reporting gap because of foreign tax administrations’ adoption of the OECD applicable date. The final regulations amend the proposed regulations to reflect the official number of the form, Form 8975, Country-by-Country Report, (Form 8975 or CbCR). As of October 31, 2016, Form 8975 has not been released.

On June 29, 2016, consistent with the proposed regulations and the OECD’s Action 13 Final Report, the Treasury released the final regulations requiring that annual country by country reporting with Form 8975 by certain U.S. persons that are the ultimate parent entity of a multinational enterprise group. The final regulations (TD 9773) affect a U.S. person that is the ultimate parent entity of a multinational enterprise group with annual revenue for the preceding annual accounting period of at least \$850 million. The completion of the form is estimated to require *approximately 4,680 hours*. The regulations are effective from June 30, 2016 although the regulations allow a U.S. person to voluntarily file a CbCR that includes the time period from January 1, 2016 in order to avoid a CbCR compliance reporting gap because of foreign tax administrations’ adoption of the OECD applicable date. The final regulations amend the proposed regulations to reflect the official number of the form, Form 8975, Country-by-Country Report, (Form 8975 or CbCR). By the time of the CLE, Form 8975 will be released but as of today it remains in comment period

Based on the available 2013 IRS statistics, approximately 8,000 U.S. corporations generate at least \$250 million revenue, of which based on the Fortune and other lists, between 2,500 and 3,000 should have a CbCR Form 8975 requirement for the year 2016. Even at current thresholds CbCR compliance is not just an OECD member country challenge. McKinsey reported in August 2016 that 700 corporations headquartered in Africa have at least \$500 million in revenue, of which 400 exceed \$1 billion.

It is likely that once the world's revenue departments learn how to manage collecting, processing, analysing and auditing the CbCR data from the initial pool of between 8,000 – 10,000 corporations in the world, the threshold will be gradually reduced until it probably applies to all corporations that generate at least \$50 million revenue (already proposed by various Tax Justice groups). It is possible that European tax justice advocates also push to yoke any corporation that has cross-border economic activity that involves a low tax jurisdiction.

The [final Regulations](#) say that the following information must be included on Form 8975 (in the form and manner to be prescribed by the IRS) with respect to each constituent entity of the U.S. MNE group, as required:

- The complete legal name of the constituent entity.
- The tax jurisdiction, if any, in which the constituent entity is resident for tax purposes.
- The tax jurisdiction in which the constituent entity is organized or incorporated (if different from the tax jurisdiction of residence).
- The tax identification number, if any, used for the constituent entity by the tax administration of the constituent entity's tax jurisdiction of residence.
- The main business activity or activities of the constituent entity. ([Reg. 1.6038-4\(d\)\(1\)](#)).

In addition, Form 8975 must contain the following information for each tax jurisdiction in which one or more constituent entities of a U.S. MNE group is resident, presented as an aggregate of the information for the constituent entities resident in each tax jurisdiction:

- Revenues generated from transactions with other constituent entities.
- Revenues not generated from transactions with other constituent entities.
- Profit or loss before income tax.
- Total income tax paid on a cash basis to all tax jurisdictions, and any taxes withheld on payments received by the constituent entities.
- Total accrued tax expense recorded on taxable profits or losses, reflecting only operations in the relevant annual period and excluding deferred taxes or provisions for uncertain tax liabilities.
- Stated capital, except that the stated capital of a PE must be reported in the tax jurisdiction of residence of the legal entity of which it is a PE unless there is a defined capital requirement in the PE tax jurisdiction for regulatory purposes.
- Total accumulated earnings, except that accumulated earnings of a PE must be reported by the legal entity of which it is a PE.
- Total number of employees on a full-time equivalent basis—see [Reg. 1.6038-4\(d\)\(3\)\(iii\)](#) for the treatment of independent contractors and other details.
- Net book value of tangible assets, which does not include cash or cash equivalents, intangibles, or financial assets. ([Reg. 1.6038-4\(d\)\(2\)](#))

The reporting period covered by IRS Form 8975 is the period of the ultimate parent entity's applicable financial statement prepared for the 12-month period (or a 52-53 week period described in Section 441(f)) that ends with or within the ultimate parent entity's tax year. If the ultimate parent entity does not prepare an annual applicable financial statement, the reporting period covered by Form 8975 is the 12-month period (or a 52-53 week period described in Section 441(f)) that ends on the last day of the ultimate parent entity's tax year. ([Reg. 1.6038-4\(c\)](#)).

3.2 Advance Pricing Agreements (APA)

Regarding Advanced Pricing Agreements, since the APA program's inception in 1991, and through the end of 2015, over 1,500 APAs have been executed. Foreign multinationals have been the heaviest users

of the procedure with the percentage of APAs executed that involved a foreign parent company in each year was 60 percent, 75 percent, 55 percent, 55 percent, and 64 percent, respectively in 2011 through 2015. On August 12, 2015 the IRS released the final revenue procedures: Procedures for Advance Pricing Agreements (Revenue Procedure 15-40) and Procedures for Requesting Competent Authority Assistance under Tax Treaties (Revenue Procedure 15-41) to supersede and replace Revenue Procedure 2006-9. The update to Revenue Procedure 2006-9, together with the update to the IRS guidance on the competent authority (“CA”) process, take account of the integration of the APA program and the mutual agreement program into the APMA Program. The revisions, however, go beyond merely reflecting the change in operating procedures as a result of the reorganization of the IRS, and change many aspects of the process of obtaining an APA as well as substantially increase the user fees.

According to the April 18, 2016 IRS Announcement and Report Concerning APAs, the number of executed APAs had increased for the previous two years (from 140 in 2012 to 145 in 2013), the summer 2014 resignations and decreased body count took a toll on 2014 APA closures, with a significant decrease to 101. The 2015 results crept up to 110 APAs executed, but the backlog increased because 183 additional APAs were submitted. Whereas the median completion time had fallen from 39.8 months in 2012 to 32.7 months in 2013, it crept back to 35.3 months for combined unilateral and bilateral APAs. The median time required to complete APAs executed in 2015 decreased to 31.9 months. Nearly three quarters of the total number of bilateral APAs executed in 2015 involved the United States entering into mutual agreements with Japan or Canada. A notable milestone achieved by APMA in 2015 was the execution of the first bilateral APA between the United States and Italy.

But U.S. clients are not just looking to the IRS for an APA any longer. Just in mid-October, the IRS announced that it had reached an agreement with Mexico’s competent authority, Servicio de Administración Tributaria (SAT), on establishing a transfer pricing framework for maquiladoras. The two countries have worked together to address SAT’s approximately 700 pending unilateral APA requests in the maquiladoras industry.

3.3 Competent Authority & Mutual Agreement Procedures (MAP)

On February 17, 2016, the Treasury Department released a revised 2016 U.S. Model Income Tax Convention (the 2016 Model) including a mandatory and binding arbitration between competent authorities. The U.S. Model Income Tax Convention was last updated in 2006 (the 2006 Model). However, as of August 25, 2016 Treasury has not released an updated technical explanation.

Arbitration, which is effectively mandatory for the tax authorities and optional for the taxpayers, has become a reality, with several cases having been decided by arbitration. It is available as a backstop to MAP under the income tax treaties with Belgium, Canada, France and Germany. Moreover, in the case of Belgium and Canada, if the MAP case is for an APA, the TPM of the prevailing party is to be used for the future APA years. Moreover, the OECD has initiated a MAP framework in 2016 that requires peer review to assess a country’s implementation.

Up from the 96 lodged in 2014 by India with \$1.2 billion of adjustments and 56 in 2013 of \$900 million of adjustment, by June of 2015 the IRS reported that the Revenue Authority of India lodged 61 new transfer pricing mutual agreement procedures with total proposed adjustments of \$1.25 billion. Following the agreement between the U.S. and India on a framework to resolve the backlog of competent authority matters, the U.S. announced in February 2016 that it will begin accepting requests for bilateral APAs between the U.S. and India. In April 2016, the IRS director of the APMA reported that India had agreed to resolution of 93 of the cases pursuant to the framework agreement. APMA will begin accepting requests for pre-filing conferences (“PFCs”) for bilateral APAs between the United States and India. In 2015, the MAP backlog has grown to 762 open cases with an average cycle time of 24 months, leading to

an average per senior manager of 109 MAP cases and 13 MAP cases per team leader, in addition to the APA open cases mentioned above.

4. Update of Select Cases and Impact on Regulation Changes

4.1 Altera

The *Altera* dispute is the first case on the cost sharing of stock-based compensation to land in Tax Court following the *Xilinx* case. In the *Altera* case, the IRS allocated more than \$80 million to the company for 2004–07, most of it based on the argument that Altera should have included costs from employee stock options in its cost sharing agreement with Altera International (a Cayman Islands affiliate). Note that the IRS has made this argument before in other disputes, initially against Seagate Technology in a dispute over the company’s 1991–92 years, and then most recently against Xilinx for its 1997–99 years. The IRS conceded the issue in Seagate, and lost the *Xilinx* case on appeal from the Tax Court to the Ninth Circuit.

Altera had disclosed its refusal to follow the 2003 cost sharing regulations in two IRS disclosure forms, arguing that sharing the cost of stock-based compensation is not consistent with the arm’s length standard set forth in Reg. § 1.482-1(b)(1). Three primary issues of dispute between Altera and the IRS were: (i) the Administrative Procedures Act, (ii) the commensurate with income standard, and (iii) the lack of comparables.

Altera contended that the final cost sharing regulation is invalid because it violates the Administrative Procedures Act, thus filing a motion for partial summary judgment. Under the Administrative Procedures Act, a final rule cannot be enforced unless it is the product of “*reasoned decision making*” and is “*consistent with the underlying statute it is designed to implement.*” According to Altera, the IRS proceeded with the 2003 cost sharing regulation in the absence of any empirical evidence showing that the rule was consistent with the arm’s-length standard. Citing an extensive record of public comments, the taxpayer stated that the IRS “could produce no evidence that unrelated parties had ever shared (or would ever share) an amount attributable to stock-based compensation in any agreement negotiated at arm’s length.”

The IRS has responded that the alleged lack of evidence is irrelevant because the contracts cited by the taxpayer as comparables are too different from the kind of qualified cost sharing agreement at issue and thus should not be considered comparable arrangements. Therefore, the “Treasury did not arbitrarily dismiss or ignore those claims,” rather, Treasury “reasonably concluded” that the contracts described by the taxpayer “do not share enough characteristics of QCSAs [qualified cost sharing arrangements] involving the development of high-profit intangibles, and therefore fail to establish that parties at arm’s length would not take stock options into account in the context of an arrangement similar to a QCSA.”

Regarding the “*commensurate with income*” standard of Section 482, the IRS argued that the 2003 regulation meets the two-step test set out by the Supreme Court in *Chevron*, and that the standard is also supported by the Supreme Court’s 2011 opinion in *Mayo Foundation* wherein the Court held that agency rules deserve deference from reviewing courts because the formulation of policy requires “more than ordinary knowledge respecting the matters subjected to agency regulations.”

Altera and the IRS filed cross-motions for summary judgment May 28, 2013 asking the U.S. Tax Court to rule as a matter of law on the question of whether parties to a cost sharing agreement must include stock based compensation in the cost pool. According to the filings with the Court, the IRS maintained that the cost sharing regulations adopted in 2003 require Altera’s Cayman Islands subsidiary to reimburse the U.S. parent for its portion of more than \$106 million in stock-based compensation paid to U.S. employees

under a cost sharing arrangement covering tax years 2004–07. In its motion, Altera argued that Treas. Reg. § 1.482-7(d)(2), which requires the inclusion of stock options in the cost pool, was invalid as a matter of law. The IRS argued that if the Court ruled that stock-based compensation must be included in the cost sharing pool, then the Court must affirm the allocation of income from Altera International to the U.S. In line with its inclusion of the stock-based compensation, the IRS increased the subsidiary's cost sharing payments for 2004–07 by greater than \$80 million in two deficiency notices.

On July 27, 2015, in a full court reviewed opinion, without dissent, the U.S. Tax Court struck down the final cost sharing regulations issued in August 2003 requiring participants in qualified cost-sharing arrangements to share stock-based compensation costs to achieve an arm's length result. The Tax Court found that Regulation § 1.482-7(d)(2) violates the arm's-length standard because the Tax Court was not presented with evidence that unrelated parties actually share such costs. The Tax Court held that the final 2003 regulations lack a "basis in fact," are invalid as a matter of law, and fail to satisfy the U.S. Supreme Court's "reasoned decision making" standard of *State Farm*.

With no dissenting opinions, this decision represents a critical victory for taxpayers. The IRS appealed to the Ninth Circuit Court of Appeals, filing its opening brief on June 27, 2016 and arguing that the Tax Court's holding was based on several related errors:

“The Tax Court erred in invalidating the 2003 cost-sharing amendments. In rendering its decision, the court erroneously relied on its prior opinion in *Xilinx* for the proposition that the arm's-length standard, as articulated in Treas. Reg. § 1.482-1(b)(1) (1994), always requires an analysis of what unrelated parties do under comparable circumstances. That fundamental error, in turn, led to the court's erroneous conclusion (ER53) that “Treasury necessarily decided an empirical question when it” determined that requiring related parties in a qualified cost-sharing arrangement (QCSA) to share stock-based compensation costs is consistent with the arm's-length standard.”¹⁴

Further, supporting the government's position in the *Altera* Case, two groups of law school professors have filed *amicus briefs* with the U.S. Court of Appeals for the Ninth Circuit. Their argument is that Treas. Reg. § 1.482-7 represents a valid exercise of the Commissioner's authority to issue regulations under IRC Section 482 and that the U.S. Tax Court erred in finding the regulation to be invalid under section 706 of the Administrative Procedure Act. Altera's reply brief is due on August 26, 2016.

4.2 Medtronic

In the June 9, 2016 U.S. Tax Court case *Medtronic, Inc. and Consolidated Subsidiaries v. Commissioner of Internal Revenue*,¹⁵ the IRS sought to apply the CPM to reallocate income from Medtronic's Puerto Rican subsidiary ("MPROC") to the U.S. parent company ("Medtronic US"). MPROC assembled Medtronic's implantable medical devices and manufactured leads for those devices in Puerto Rico. Until 2002, MPROC had operated as a U.S. company that qualified for the Section 936 tax credit. With the repeal of Section 936, the Puerto Rican operation was reorganized as a Puerto Rican company that, unlike its predecessor, operated under an intercompany license agreement with Medtronic US.

¹⁴ Altera Corp v Commr, TC, Case: 16-70497, 06/27/2016, ID: 10030144, DktEntry: 25, Altera Brief Appellant, page 40 of 93.

¹⁵ *Medtronic, Inc. and Consolidated Subsidiaries v. Commissioner of Internal Revenue* TC Memo 2016-112.

The IRS's application of the CPM method assumed that all intangibles that MPROC needed to perform finished manufacturing, other than assembled workforce and incremental processing intangibles that MPROC had developed since entering into its intercompany license agreement with Medtronic US in 2002, were the subject of that intercompany license agreement. Under the IRS's CPM method, MPROC's adjusted income was based on the rates of return on operating assets earned by comparable manufacturers in the medical device industry. The residual income – that is, Medtronic's overall income derived from the medical devices that MPROC manufactured *minus* the CPM income allocated to MPROC – was allocated to Medtronic US.

The Tax Court recognized that in 1986 the Congress amended IRC Section 482 to provide in the income with respect to any transfer or license of intangible property should be commensurate with the income attributable to the intangible property. The Tax Court cited the U.S. Treasury Department's statements in its 1988 White Paper and various other publications that the "commensurate with income" requirement of the 1986 amendment to IRC Section 482 was designed to operate consistently with the arm's length standard.

The Tax Court concluded that the income allocated to MPROC under the IRS's CPM method was understated because it did not credit MPROC for the high quality of the products it manufactured. Based on the evidence presented by Medtronic, the Tax Court concluded that product quality was the "single greatest factor in terms of market share" and the "*sine qua non* of success within the implantable device industry." The Tax Court opinion appears to conclude that MPROC's assembled workforce and possibly incremental processing intangibles that MPROC had developed since entering into its intercompany license agreement with Medtronic US in 2002 contributed significantly to product quality and were not adequately compensated by the CPM rates of return earned by other medical device providers. Consequently, the Tax Court concluded that assembled workforce and incremental processing intangibles were not covered by the intercompany license agreement and not subject to the "commensurate with income" requirement.

The *Medtronic* case provides a preview of the potential legal analysis tax tribunals may apply to evaluate complex economic measurements and determinations where a VCA is leveraged to allocate profits to the economic activity that produced these profits and to align to value creation for a comparable profit-split method or a transactional-profit method.

4.3 Microsoft leads to New Regulation for 7602: IRS Can Use Third party Contractors

On July 14, 2016, the IRS finalized regulations that allow for the IRS to engage contractors to participate in interviews of witnesses summoned by the IRS to provide testimony under oath.¹⁶ These final regulations modify regulations under section 7602(a) of the IRC relating to administrative summonses. In particular, these final regulations clarify that persons with whom the IRS or the Office of Chief Counsel contracts for services described in section 6103(n) for services, including outside economists, engineers, consultants or attorneys, may receive books, records or other data summoned by the IRS "and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a person who the IRS has summoned as a witness to provide testimony under oath."

These regulations may have an effect on taxpayers, a taxpayer's officers or employees, and any third party who is served with a summons, as well as any other person entitled to notice of a summons. The final regulations follow temporary regulations¹⁷ and identical cross-referencing proposed regulations¹⁸

¹⁶ T.D. 9778 (Jul 14, 2016).

¹⁷ T.D. 9669.

issued in 2014. However, the agency made one change to the temporary regulations, replacing the word “examine” with “review” when describing what contractors may do with documents received by the IRS under a summons. “This revision clarifies that the regulations do not permit contractors to direct examinations (i.e., audits) of a taxpayer’s return,” the IRS said. The regulations take effect on July 14, the date they are scheduled to appear in the Federal Register.

The IRS is doubling down on its argument that outside contractors should be allowed to participate in audits, issuing final rules intended to cement the practice that Microsoft Corp. attorneys opposed during a dispute over taxes on \$38 billion in royalties.

In *United States v. Microsoft Corp.*, the company argued that the IRS is not entitled to judicial enforcement of a series of designated summonses in a transfer pricing audit because the agency improperly delegated its authority to an outside law firm.¹⁹ The district court enforced the summons, relying on the broad scope of Section 7602.

The topic is at the core of Microsoft Corp.’s defense against two consolidated summons enforcement actions in an audit of its transfer pricing. Microsoft challenged the legitimacy of the temporary regulations and argued in federal district court filings that the contract was an illegal outsourcing of “an inherently governmental function”.²⁰ In supporting Microsoft Corp.’s argument that such practices are illegal, Sen. Rob Portman introduced a bill that would restrict access to taxpayer returns based on confidentiality and disclosure standards. The bill would add new language to Section 7602, restricting the IRS from delegating audit authority to non-agency personnel.

4.4 Proposed 367(d) Regulations

October 5, 2015 Treasury published these proposed regulations under Section 367 with coordinating temporary regulations under Section 482 to thwart tax strategies employed to reduce the value of an intangible transferred to a foreign affiliate. In brief summary, Section 367(d) provides that a U.S. transferor that transfers intangibles to a related group member is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of the intangible. The U.S. transferor will be deemed to receive amounts that are commensurate with the income attributable to the intangible over the useful life of such property. However, if the intangible is alienated by the foreign group member, then the full amount, measured over the useful life, will be due at that time of the foreign disposition.

Treasury called out three valuation mitigation strategies:

- (1) that taxpayers are using valuation methods that value items of intangibles on an item-by-item basis, instead of an aggregate basis that Treasury contends will achieve a more reliable arm’s length result;
- (2) that taxpayers do not properly perform a full factual and functional analysis of the business in which the intangible property is employed, and
- (3) that taxpayers are asserting a broad interpretation that apportions significant value to the foreign goodwill and foreign going concern value because of a business’ foreign customers whereas Treasury

¹⁸ REG-121542-14

¹⁹ *United States v Microsoft Corp*, No 2:15-cv-00102-RSM (WD Wash), Order Granting Enforcement of Summons (Nov 20, 2015).

²⁰ 24 Transfer Pricing Report 739 (Oct 15, 2015).

contends that a U.S. business which is operated primarily by U.S. employees should be apportioned a lion's share of the goodwill and going concern value.

In response to these and other valuation compression strategies, Treasury proposed five significant changes for the treatment of intangibles under Section 367(d):

- (1) The outbound transfer of foreign goodwill and going concern value will now attract Section 367 recognition.
- (2) The active trade or business exception of Section 367(a) will now be restricted from applying to goodwill and going concern value.
- (3) Aggregate valuation must be applied to interrelated intangibles transactions.
- (4) Treasury will eliminate the 20 year limitation for an intangible's useful life.
- (5) Taxpayers must apply the best method rule of the Section 482 regulations.

4.5 State Aid Cases & Other EU Initiatives Impacting U.S. Clients

Since June 2013, the EU Commission has been investigating the tax ruling practices of Member States. It extended its investigation of tax ruling practices to all Member States in December 2014. Besides its 2015 decision in the Starbucks and Fiat cases, the EU Commission also has three ongoing in-depth investigations where it raised concerns that tax rulings may give rise to state aid issues, concerning Apple in Ireland, Amazon in Luxembourg, and a Belgian tax scheme.

On August 24, 2016 U.S. Treasury issued a White Paper formally criticizing the EU Commission's approach as new and departing from prior EU case law and commission decisions. The U.S. Treasury stated that the EU Commission has advanced several previously unarticulated theories as to why its Member States' generally available tax rulings may constitute impermissible State aid in particular cases. Such a change in course, which has required the Commission to second-guess Member State income tax determinations, was an unforeseeable departure from the status quo. U.S. Treasury has stated that it will explore retaliatory options if the State Aid penalties are applied retroactively to U.S. MNEs.

Fiscal State aid rules are not the only EU tax regulations having a direct impact upon multinational companies in Europe. Although EU and OECD tax policy are often aligned to a large degree, many EU tax experts observe that EU regulations often are more complex, rigorous, and expand well-beyond the requirements established by the OECD's Model Tax Convention (MTC). In several key areas of corporate related taxation and tax practice, such as the tax avoidance rules, the EU has surpassed the OECD's rules for addressing tax avoidance by multinational companies doing business within the EU's internal market. For example, in January 2016 the European Commission released its version of the Anti-Tax Avoidance Package, commonly referred to as the "EU BEPS Plan." One of the central items of this Anti-Tax Avoidance Package is the newly proposed EU Directive recommended by the European Commission that imposes enactment of domestic regulations against tax avoidance practices by MNEs that would directly affect the functioning of the internal market under EU law.

The EU's newly proposed Anti-Avoidance Package comprises four main documents: an Anti-Tax-Avoidance Directive (ATA Directive); a Recommendation on Tax Treaties; a Revised Administrative Cooperation Directive; and a Communication on External Strategy on Effective Taxation. This package collectively addresses seven critical areas of European corporate taxation including the deductibility of interest between related companies and the mandatory automatic exchange of information regarding CbCR, among others. The package's new rules are more comprehensive in application than the OECD's MTC and far more complex. The EU Anti- Tax Avoidance Proposal is important for practitioners as its highly likely that it will be adopted by the EU in the near future and aligned to the wider applicable

OECD's BEPS as well as the Common Consolidated Corporate Tax Base (CCCTB) when it is re-launched towards the end of 2016.

**Texas State Bar Tax Section
International Tax Update 2016**

**Transfer Pricing Update, Country-by-Country
Reporting, and MAP**

Nov 3 Dallas and Nov 4 Houston



Prof. William Byrnes

Presenter Prof. William Byrnes

- Lexis' **Practical Guide to U.S. Transfer Pricing**
- Lexis' **Taxation of Intellectual Property and Technology**
- online **Risk Management** program at Texas A&M University Law for industry professionals

williambyrnes@tamu.edu

Objectives

Upon completion of the session, you will:

1. Obtain an awareness of the Proposed Regs for 1.367(d)
2. Understand the changes in the LB&I structure and its audit focus
3. Learn about key case decisions in the US and EU that impact clients in 2016
4. Know which OECD Transfer Pricing Guidelines have been amended and which ones will be amended next year
5. Be exposed to the new multinational global reporting regimes of the USA and the OECD

Agenda

TOPIC	TIME
2015/16 IRS LB&I Restructure	<10> minutes
2016 BEPS' OECD TPG Amendments	<10> minutes
CbCR & Form 8975 MAP & Competent Authority	<10> minutes
Notable Cases, § 1.367(d), State Aid Cases	<10> minutes
Questions and Answers	<5> minutes

2015/16 IRS LB&I Restructure & Its Impact



IRS LB&I Restructure

Old: LB&I functions split international / domestic

New: Single deputy commissioner

Reporting?

- Support Areas
- Practice Areas: Issue or Geographic Compliance Focused

IRS LB&I Restructure

Support Areas

- Asst Deputy Comm of Compliance Integration
- Asst Deputy Comm International
- Director of Program and Business Solutions

IRS LB&I Restructure

Practice Areas: 3 of 5 Int'l Issue Focused

1. Cross Border Activities Practice Area
- 2. Treaty and Transfer Pricing Operations Practice Area (“TTPO”)**
3. Withholding and International Individual Compliance Practice Area
4. Enterprise Activity Practice Area
5. Pass Through Entities Practice Area

IRS LB&I Restructure

Practice Areas: 5 Geographic Compliance Centered

1. Compliance Practice Areas
2. Central Compliance Practice Area
3. Eastern Compliance Practice Area
4. Northeastern Compliance Practice Area
5. Western Compliance Practice Area

IRS LB&I Restructure

Out with the Old

- Coordinated Industry Cases (CIC)
- Compliance Assurance Program (CAP)
- Field Examiner Opens New Audit Issues

In with the New

- Risk Identified (Analytics, Percolate Up)
- Campaigns
- Coordinated Teams of Issue + Geography

IRS LB&I Restructure

Risks → Campaign ?

coordinated audit groups leverage risk based approach

1. Weigh the size of the compliance risk?
2. How often the risk is occurring?
3. Where is risk occurring?
4. Is risk is a result of a promoted scheme?

IRS LB&I Restructure

Risks → Campaign ?

If Campaign issued, then allocate divisional resources among the campaigns.

Measurement of performance may shift

of case closures →

of case openings + time expended on each case

IRS LB&I Restructure

“Principles of Collaboration” (IRM 2016)

encourage greater and more transparent
interaction among taxpayers, examiners, and
LB&I leadership



Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10

2015 Final Reports





OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations



JULY 2010

OECD/G20 Base Erosion and Profit Shifting
Project



Transfer Pricing Documentation and Country-by-Country Reporting

ACTION 13: 2015 Final Report



New US CbCR Form 8975

- The complete legal name of the constituent entity.
- The tax jurisdiction, if any, in which the constituent entity is resident for tax purposes.
- The tax jurisdiction in which the constituent entity is organized or incorporated (if different from the tax jurisdiction of residence).
- The tax identification number, if any, used for the constituent entity by the tax administration of the constituent entity's tax jurisdiction of residence.
- The main business activity or activities of the constituent entity

New US CbCR Form 8975

1. Revenues generated from transactions with other constituent entities.
2. Revenues not generated from transactions with other constituent entities.
3. Profit or loss before income tax.
4. Total income tax paid on a cash basis to all tax jurisdictions, and any taxes withheld on payments received by the constituent entities.
5. Total accrued tax expense recorded on taxable profits or losses, reflecting only operations in the relevant annual period and excluding deferred taxes or provisions for uncertain tax liabilities.

New US CbCR Form 8975

6. Stated capital, except that the stated capital of a PE must be reported in the tax jurisdiction of residence of the legal entity of which it is a PE.
7. Total accumulated earnings, except that accumulated earnings of a PE must be reported by the legal entity of which it is a PE.
8. Total number of employees on a full-time equivalent basis
9. Net book value of tangible assets, which does not include cash or cash equivalents, intangibles, or financial assets.



MAP cases initiated completed by year



Notable 2015/16 Cases

Altera full Tax Court strikes down cost sharing regs,
IRS Appeals with many tax pros joining IRS friendly
Amicus briefs

Medtronic: IRS changes mind about MOU, applies
CPM, Court rejects and uses its own CUT

Microsoft and IRS use of outside counsel, largest
dispute yet? Leads to New Reg

Valuation Compression for § 1.367(d)

1. Value items item-by-item instead of aggregate
2. Poor factual and functional analysis
3. Weight significant value to the foreign goodwill and foreign going concern value based on foreign customers, ignore U.S. business and U.S. employees

Solutions of Proposed § 1.367(d)

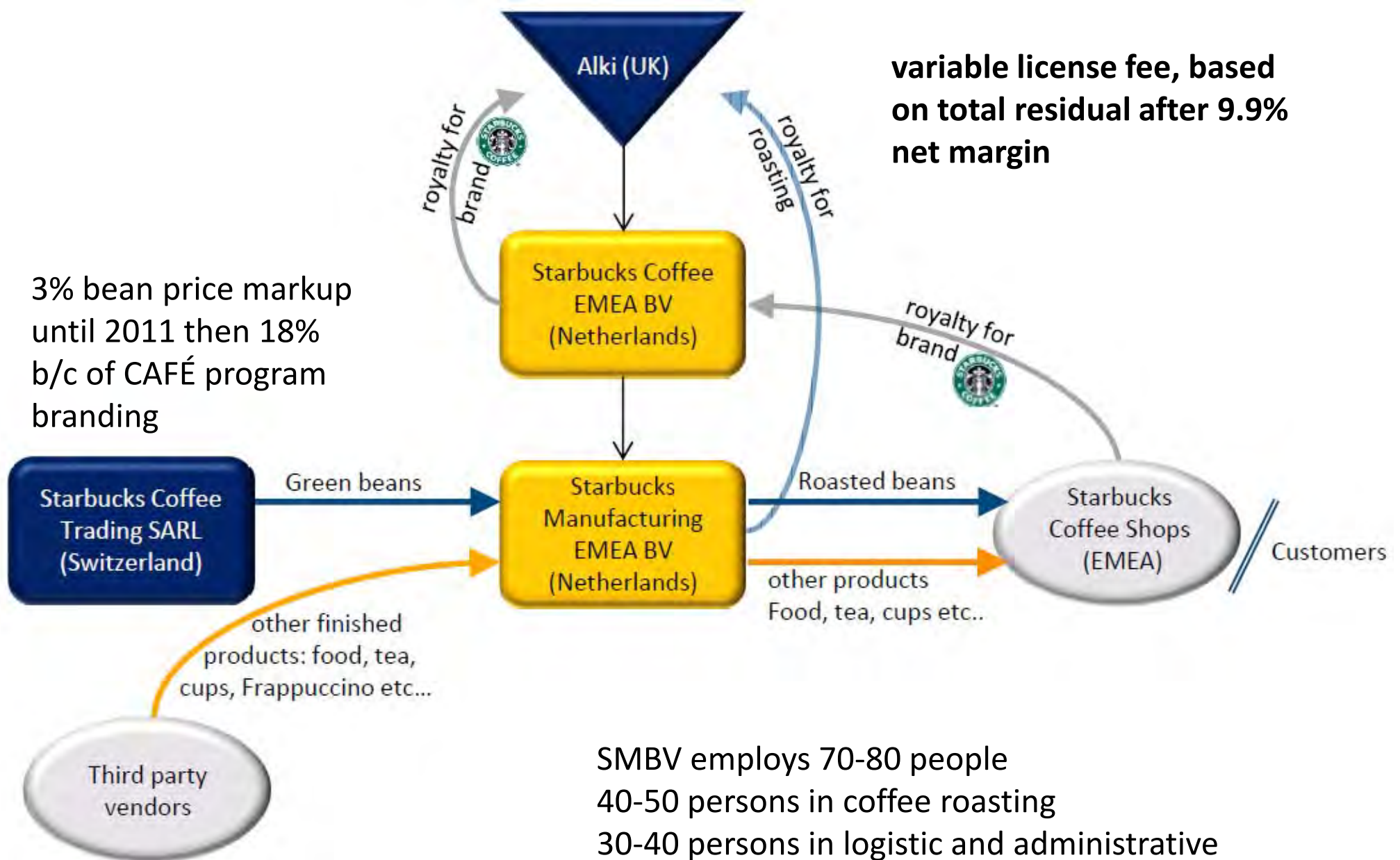
- (1) outbound transfers of foreign goodwill and going concern value will attract § 367
- (2) the active trade or business exception restricted from applying to goodwill and going concern value
- (3) aggregate valuation
- (4) elimination of the 20 year limitation for useful life
- (5) application of the best method rule

State Aid Cases



So how much does it cost to “roast” a cup ?





SMBV employs 70-80 people
40-50 persons in coffee roasting
30-40 persons in logistic and administrative
9.9% net margin on operating costs excluding COGs and intangible fees



Starbucks obtained illegal tax advantage from the Netherlands



**How much of this dollar should I apportion to
the function of roasting ?
and each other function of the value chain?**



Source: <http://thinkmcflythink.squarespace.com/pop-culture/2012/11/29/starbucks-responds-to-slowing-economy-with-7-cup-of-coffee.html>

**Is the Starbucks roast just another cup of
coffee?**



Intangible Value for Roasting Processes?



Example Financials Databases

→ Profit Level Indicators

- *Bureau van Dijk*
- Amadeus
- Orbis
- ktMINE
- *RoyaltyStat*
- *Standard & Poor's ("S&P")*
- *Thomson Reuters' OneSource*
- *LexisNexis, Dun & Bradstreet, Bloomberg.*



U.S. International Taxation

**International Tax Symposium
Dallas, Texas
Houston, Texas**

November 3 & 4, 2016

WILLIAM H. HORNBERGER
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CHAPTER I: INTRODUCTION

A. Foreign Persons Doing Business or Investing in the U.S.. Foreign persons who plan to do business in the United States or invest in a new or existing U.S. business entity are faced with a myriad of business, legal and tax issues. U.S. counsel advising foreign persons regarding the ownership structure for a contemplated business or investment in the United States should have a basic understanding of the U.S. system of international taxation of foreign persons.

Nonresident aliens and foreign corporations are subject to U.S. federal income taxation on their taxable income that is effectively connected with the conduct of a U.S. trade or business. The U.S. also imposes a 30% tax (or such lesser rate as is provided by an applicable income tax treaty) on the gross amount of U.S. source interest, dividends, rents, royalties and other fixed, determinable, annual or periodical income from U.S. sources of nonresident aliens and foreign corporations if such income is not effectively connected with the conduct of a U.S. trade or business. In addition, foreign corporations doing business in the U.S. are subject to the branch profits tax.

U.S. income tax treaties often modify the general rules of taxation for nonresident aliens and foreign corporations doing business or investing in the U.S. An applicable income tax treaty may reduce or eliminate the 30% gross-basis tax imposed on nonresident aliens and foreign corporations. In addition, an applicable income tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment.

For U.S. federal estate and gift tax purposes, nonresident aliens are subject to U.S. federal estate and gift tax on their “property situated in the U.S.” U.S. estate tax treaties may affect the determination of whether an alien is domiciled in the U.S. for U.S. estate tax purposes.

The general pattern of U.S. international taxation of foreign persons gives rise to a host of issues that a U.S. advisor should consider when developing the structure for a business or investment in the U.S., including:

1. How is income sourced for U.S. federal income tax purposes?
2. Will the foreign person be engaged in the conduct of a U.S. trade or business?
3. Will income generated by the foreign person be treated as effectively connected with a trade or business conducted by such foreign person?
4. If a foreign person does business or invests in the U.S. through a U.S. or foreign entity, how will the entity be treated for U.S. federal income tax purposes?
5. If a foreign person’s taxable income is effectively connected with the conduct of a U.S. trade or business, what is the method and rate of U.S. federal income taxation of such income?

6. What is the branch profits tax and how does it apply to foreign corporations doing business in the U.S.?

7. What is the method and rate of U.S. federal income taxation on a foreign person's U.S. source fixed or determinable annual periodical income?

8. What special U.S. federal income tax considerations apply to foreign persons owning or disposing of a U.S. real property interest?

9. What is the function of income tax treaties and how do they modify the general U.S. rules of federal income taxation?

10. What special U.S. federal estate and gift tax considerations apply to foreign persons doing business or investing in the U.S.

11. What special financing considerations apply to foreign-owned U.S. corporations?

B. U.S. Taxation of U.S. Citizens and Residents and U.S. Corporations. U.S. citizens, resident aliens and U.S. corporations are generally subject to U.S. income taxation on their worldwide income. To avoid double taxation of income earned abroad, the U.S. allows a credit for income taxes paid to foreign countries with respect to foreign source income. The U.S. also allows certain U.S. corporate shareholders in foreign corporations to claim a credit (known as the indirect or deemed-paid credit), generally in the year the foreign corporation pays a dividend, for foreign income taxes paid by the foreign corporation.

CHAPTER II: SOURCES OF INCOME

A. Statutory Framework. The Internal Revenue Code¹ generally divides income into two categories -- domestic source income, which is income from sources within the U.S., and foreign source income, which is income from sources outside the U.S.² Sections 861 through 865 of the Code set forth the rules for determining whether the source of income is domestic or foreign for U.S. federal income tax purposes.³ Section 861(a) lists specific types of gross income that are treated as income from sources within the United States, while Section 862(a) lists specific types of gross income that are treated as income from sources without the United States.⁴ The specific types of income listed within Sections 861(a) and 862(a) include interest, dividends, compensation for personal services, rentals and royalties, income from sales of real property, and income from sales of inventory property.

Section 863 provides source rules for those items of gross income, expenses, losses, and deductions not listed in Sections 861(a) and 862(a) of the Code.⁵ Section 863(a) requires that items not enumerated in Sections 861(a) and 862(a) “shall be allocated or apportioned to sources within or without the United States.” This treatment is mandatory for determining the source of all items governed by Section 863.⁶ Section 863, however, does not prescribe the specific sourcing rules for nonenumerated items, but rather gives the Secretary of the Treasury the authority to promulgate regulations covering such sourcing rules.⁷

Section 863(b) describes certain types of transactions that create “income partly [from] within and partly [from] without the United States.” The types of transactions described within Section 863(b) include income from the sale of inventory property produced by the taxpayer within and sold without the United States, or produced without and sold within the United States.⁸ For taxable income arising from these types of transactions, Section 863(b) provides that a portion of such taxable income be sourced domestically as determined by “processes or formulas of general apportionment prescribed by the Secretary.” The remainder is foreign source income.⁹

Section 864 provides certain definitions and special rules for purposes of Sections 861 through 865. Section 865 provides special sourcing rules for income from the sale of certain personal property.

¹All references in this outline to the “Internal Revenue Code” or to the “Code” refer to the Internal Revenue Code of 1986, as amended. Unless otherwise noted, all “Section” references are to the Internal Revenue Code.

²See I.R.C. §§ 861-865; *Intel Corp. v. Commissioner*, 100 T.C. 616, 621-22 (1993) (discussion of statutory framework and legislative history underlying source rules), *aff’d*, 76 F.3d 976 (9th Cir. 1995); see generally 3 Boris I. Bittker & Lawrence Loken, *Federal Income Taxation of Income, Estates and Gifts* ¶ 73.1 (3rd ed. 2010) (overview of source rules).

³*Intel Corp.*, 100 T.C. at 621.

⁴*Id.* at 621-22.

⁵*Id.* at 622.

⁶*Id.* at 623.

⁷*Id.* at 623.

⁸I.R.C. § 863(b)(2).

⁹I.R.C. § 863(b); *Intel Corp.*, 100 T.C. at 623.

B. Sources of Specific Types of Income. The most common types of income that require a determination of source include interest, dividends, personal services income, rents and royalties, income from real estate sales, income from sales of non-inventory personal property and income from sales of inventory.

1. Interest.

a. U.S.-Source Interest. Interest from the United States is from U.S. sources.¹⁰ Also, interest is generally from U.S. sources if such interest is accrued on an obligation of a noncorporate U.S. resident¹¹ or a domestic corporation.¹² This general rule is subject to an exception, with respect to tax years beginning before January 1, 2011,¹³ for interest accrued on an obligation of a resident alien or domestic corporation if such individual or corporation meets the 80-percent foreign business requirement of Section 861(c)(1)(A) of the Code (the “80/20 rule”). An individual or corporation meets the 80-percent foreign business requirement of the 80/20 rule if, for the three prior tax years, at least 80-percent of the gross income of such individual or corporation (i) is foreign source; and (ii) attributable to the active conduct of a trade or business in a foreign country by the individual or corporation.¹⁴ If the obligee is a related person, a special look-through rule applies.¹⁵ The 80/20 rule has been

¹⁰I.R.C. § 861(a)(1); Treas. Reg. § 1.861-2(a)(1).

¹¹The Treasury Regulations expand the scope of the type of obligors that are subject to this sourcing rule. Treasury Regulation Section 1.861-2(a) provides that gross income from the U.S. includes interest from a “resident of the United States” The term “resident of the United States,” as used in this regulation, includes (i) an individual who at the time of payment of the interest is a resident of the United States; (ii) a domestic corporation; (iii) a domestic partnership which at any time during its tax year is engaged in a U.S. trade or business; or (iv) a foreign corporation or foreign partnership which at any time during its tax year is engaged in a U.S. trade or business. Treas. Reg. § 1.861-2(a)(2).

¹²I.R.C. § 861(a)(1); see *Housden v. Commissioner*, 63 T.C.M. (CCH) 2063, 2066 (1992) (“The home base of the payor, rather than the place of payment or location of the debt instrument, is the critical factor in determining the source of interest.”); see also *Container Corp. v. Commissioner*, 134 T.C. 122, 140 (2010) (We do not choose International as the source of the income because the guaranty fees were not like alimony: Alimony is only an obligation to pay, because once a court orders one spouse to pay alimony, nothing more is required of the other spouse. Guaranty fees are different--they are payments for a possible future action. We think that makes guaranties more analogous to services. Guaranties, like services, are produced by the obligee and so, like services, should be sourced to the location of the obligee. See secs. 861(a)(3), 862(a)(3); Hunt, 90 T.C. at 1301. We realize that we are deciding a close question, but an analogy to interest has too many shortcomings: Guaranty fees do not approximate the interest on a loan; Vitro, not International, produced the guaranty fees; and Vitro’s guaranty was not an obligation to pay immediately, but a promise to possibly perform a future act.”); cf. F.S.A. 200147033 (Nov. 23, 2001) (“There is no explicit sourcing rule for guarantee fees. Guarantees must instead be sourced by analogy to the closest enumerated income item. Interest income is the closest such item. Under section 861(a)(1), interest paid by a U.S. corporation, such as taxpayer, generally is treated as income from sources within the United States. Although the fees are sourced like interest, they are not characterized as interest, because they are not payments for the use or forbearance of money. Accordingly, guarantee fees are other FDAP potentially subject to tax at the rate of 30%. * * * The guarantee fees are not interest within the meaning of Article A of the U.S.-Country A treaty. The payments constitute “other income” taxable at the full U.S. statutory rate of 30 percent unless sufficient facts establish that the payments constitute industrial and commercial profits to A.”). Private letter rulings, technical advice memoranda and field service advice are not binding as “precedent.” These published administrative positions, however, are often a substantial indication of the position of the Internal Revenue Service on an issue.

¹³Pub. L. No. 111-226, § 217(d)(1). 124 Stat. 2389.

¹⁴I.R.C. § 861(c).

¹⁵I.R.C. § 861(c)(2).

repealed effective for tax years beginning after December 31, 2010.¹⁶ The new law provides a grandfather rule for any domestic corporation that (1) meets the 80/20 rule for its last taxable year beginning before January 1, 2011 (“an existing 80/20 company”), (2) meets a “new 80/20 test” with respect to each taxable year beginning after December 31, 2010, and (3) has not added a substantial line of business with respect to such corporation after the date of enactment of this provision.¹⁷ Any payment of dividend or interest after December 31, 2010, by an existing 80/20 company that meets the grandfather rule will be exempt from withholding tax to the extent of the existing 80/20 company’s active foreign business percentage.¹⁸ Nonetheless, any payment of interest will be treated as U.S.-source income.¹⁹

In the case of foreign corporations and foreign partnerships engaged in the conduct of a trade or business in the United States, interest paid by such U.S. trade or business is treated as U.S. source income.²⁰

b. Foreign-Source Interest. Interest if from a foreign source if it is not U.S.-source interest.²¹

2. Dividends.

a. U.S.-Source Dividends.

(1) General Rule. Dividends are generally from a U.S. source if such dividends are generated by a domestic corporation or a qualifying foreign corporation.²²

(2) Qualifying Foreign Corporation. A portion of the dividends paid by a foreign corporation are U.S.-source if 25 percent or more of the foreign corporation’s gross income for the preceding three years was effectively connected with the conduct of a U.S. trade or business.²³ A statutorily-prescribed ratio determines the portion of the dividends that is treated as U.S. source income.

b. Foreign-Source Dividends. Dividends are treated as foreign source income if not derived from U.S. sources.²⁴

3. Personal Service Income.

a. U.S.-Source Income. Income from personal services performed in the U.S. is from U.S. sources unless the following three requirements are met:

¹⁶ Pub. L. No. 111-226, § 217(a). 124 Stat. 2389.

¹⁷ See Pub L. No. 111-226, § 217(b)(2), enacting new I.R.C. §§ 871(i)(2)(B), 871(l). 124 Stat. 2389.

¹⁸ New I.R.C. § 871(i)(2)(B), 871(l).

¹⁹ Joint Committee on Taxation Report [JCS-2-10] (8/16/2010).

²⁰ See I.R.C. § 884(f)(1); § 861(a)(1)(C) (added by the American Jobs Creation Act of 2004).

²¹ I.R.C. § 862(a)(1).

²² I.R.C. § 861(a)(2)(A).

²³ I.R.C. § 861(a)(2)(B).

²⁴ I.R.C. § 862(a)(2).

(1) The services were performed by a nonresident alien who was not present in the U.S. for more than 90 days during the taxable year;

(2) The service income does not exceed \$3,000 in the aggregate; and

(3) The income is from services performed as an employee of or under a contract with either:

(a) A nonresident alien, foreign partnership or corporation that is not engaged in business in the U.S.; or

(b) A U.S. citizen, resident, or domestic partnership or corporation if such services are for its foreign office.²⁵

b. Foreign-Source Income. Income from personal services performed outside the U.S. is from a foreign source.²⁶

c. Services Performed Partly Within and Partly Without the U.S. If performance of services is partly within and partly without the U.S., the amount of compensation included in U.S. source income is determined on the basis that most correctly reflects the proper source of income under the facts and circumstances.²⁷ The Treasury regulations provide that, in many cases, the facts and circumstances will be such that an apportionment on a time basis will be acceptable.²⁸

The Treasury regulations contain special rules applicable to individuals. The regulations contain the facts and circumstances basis as the general rule for determining the source of compensation for labor and personal services performed partly within and partly without the United States received by persons other than individuals and by individuals who are not employees.²⁹ The regulations, however, provide two general bases for determining the proper source of compensation that an individual receives as an employee for such labor or personal services.³⁰ Under the first general basis, an individual who receives compensation, other than compensation in the form of certain fringe benefits, as an employee for labor or personal services performed partly within and partly without the United States is required to source such compensation on a time basis.³¹ Under the second general basis, an individual who receives

²⁵I.R.C. § 861(a)(3).

²⁶I.R.C. § 862(a)(3).

²⁷Treas. Reg. § 1.861-4(b)(1); *cf.* PLR 200244017 (May 24, 2002) (25% contingency fee paid by law firm to nonresident alien lawyer allocated between U.S. and foreign sources on a time basis).

²⁸Treas. Reg. § 1.861-4(b)(1)(i); *see Bailey v. United States*, 1997 WL 759654 (Ct. Fed. Cl. 1997) (“Without evidence of how many days plaintiff spent in Canada and how many he spent in the United States, this court has no information by which it may determine, with accuracy, the portion of income subject to United States tax. Because the plaintiff has failed to provide any such evidence, all compensation should be included in United States gross income, pursuant to Treas. Reg. § 1.861-4(a) & (b).”), *aff’d*, 200 F.3d 785 (Fed. Cir. 1999).

²⁹Treas. Reg. § 1.861-4(b)(1)(i).

³⁰Treas. Reg. § 1.861-4(b)(2)(ii).

³¹Treas. Reg. § 1.861-4(b)(2)(ii)(A).

compensation as an employee for labor or personal services performed partly within and partly without the United States in the form of fringe benefits is required to source such compensation on a geographical basis.³²

Treasury and the Revenue Service recognize that there are circumstances in which these two general bases may not be the most appropriate basis for determining the source of an employee's compensation for labor or personal services performed partly within and partly without the United States. Accordingly, the regulations provide that an employee may use an alternative basis, based upon the facts and circumstances, to source such compensation if he or she establishes to the satisfaction of the Commissioner that such an alternative basis more properly determines the source of the compensation.³³ For example, when an employee's compensation is tied to the performance of specific actions rather than earned ratably over a specific time period, an alternative basis may more properly determine the source of compensation than the bases for determining source of compensation.³⁴

On October 17, 2007, the Service published proposed regulations to clarify the determination of source of compensation of a person, including an artist or athlete, who is compensated for labor or personal services performed at an event.³⁵

4. Rents and Royalties.

a. U.S.-Source Income. Rents and royalties are from U.S. sources if derived from one of the following:

(1) The rental of real or tangible personal property situated in the U.S.; or

(2) The use of intangible property (for example, copyright, patent, secret process or formula) in the U.S.³⁶

b. Foreign-Source Income. Rents and royalties are from foreign sources if derived from one of the following:

(1) The rental of real or tangible personal property situated outside the U.S.; or

³²Treas. Reg. §1.861-4(b)(2)(ii)(B) and (D); *see generally* "LB&I International Practice Service Concept Unit – Sourcing of Fringe Benefits for FTC Limitation," *reprinted at* 2015 TNT 163-51 (helpful summary of rules).

³³Treas. Reg. §1.861-4(b)(2)(ii)(C)(1)(i).

³⁴*See* Preamble to Withdrawal of Notice of Proposed Rulemaking and Notice of Proposed Rulemaking, Reg-136481, 69 F.R. 47816-47822, *reprinted at* 2004 TNT 152-3.

³⁵*See* REG-114125-07, 72 F.R. 58787-58790, *reprinted at* 2007 TNT 201-10.

³⁶I.R.C. § 861(a)(4); *cf.* F.S.A. 200222201 (Feb. 26, 2001) (contingent royalties paid by domestic licensee to foreign corporation licensor for worldwide computer software rights constitute U.S. source income where licensee modifies, may reproduce, and sublicenses software wholly within the U.S. to a domestic licensee for integration into the sublicensees computers sold to customers both within and outside the U.S.); F.S.A. 200139022 (Sept. 28, 2001) (lump sum payment made pursuant to settlement agreement executed to settle patent infringement litigation characterized as U.S.-source royalty income).

(2) The use of intangible property outside the U.S.³⁷

On September 30, 1998, the Internal Revenue Service issued final regulations effective October 2, 1998, clarifying “the treatment under certain provisions of the Code and tax treaties of income from transactions involving computer programs.”³⁸ Under the final regulations, the determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership of the copyrighted article have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income.³⁹

5. Real Estate Sales.

a. U.S.-Source Income. Gain from the sale of real property located in the U.S. is considered U.S.-source gain.⁴⁰

b. Foreign-Source Income. Gain from the sale of real property located outside the U.S. is considered foreign-source gain.⁴¹

6. Sales of Non-Inventory Property.

a. U.S.-Source Income. With certain exceptions, income realized by a U.S. resident from the sale of non-inventory personal property is generally treated as U.S.-source income.⁴² For purposes of Section 865, a “U.S. resident” generally means a U.S. citizen or a resident alien who does not have a tax home (as defined in Section 911(d)(3)) in a foreign

³⁷I.R.C. § 862(a)(4).

³⁸T.D. 8785, 1998-2 C.B. 494, *corrected by* 1998-2 C.B. 741. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under section 861(a)(4) or section 862(a)(4), as appropriate. Treas. Reg. § 1.861-18(f)(2).

³⁹Treas. Reg. § 1.861-18(f)(2).

⁴⁰I.R.C. § 861(a)(5).

⁴¹I.R.C. § 862(a)(5).

⁴²I.R.C. §§ 865(a)(1), 865(b); *cf.* I.R.C. §§ 865(c)(exception for depreciable personal property), 865(d)(exception for intangibles). Under Section 865(d), gain derived from the sale of an intangible asset (in excess of amortization deductions) by a U.S. resident will generally be sourced in the United States to the extent the payments in consideration for the sale are not contingent on the production, use or disposition of the property. I.R.C. § 865(d)(1)(A). If payments are so contingent, the source rule for royalties applies to the gain. I.R.C. § 865(d)(1)(B). Section 865(d)(2) defines “intangible” to include, among other things, secret processes, or formulas, goodwill, trademarks, and franchises. Section 865(d)(3) then provides a special rule for goodwill, sourcing it in the country in which it was generated. *See also International Multifoods Corp. v. Commissioner*, 108 T.C. 25, 37 (1997), *supplemental opinion at* 108 T.C. 579 (“[W]e believe that Congress’ enumeration of goodwill in section 865(d)(2) as a separate intangible asset necessarily indicates that the special sourcing rule contained in section 865(d)(3) is applicable only where goodwill is separate from the other intangible assets that are specifically listed in section 865(d)(2).”).

country; a nonresident alien who has a tax home in the U.S.; and any corporation, trust or estate which is a U.S. person.⁴³

b. Foreign-Source Income. With certain exceptions, income realized by a nonresident from the sale of non-inventory personal property is generally sourced outside the U.S.⁴⁴ For purposes of Section 865, a “nonresident” means a person other than a U.S. resident (as defined in Section 865(g)(1)(A)).⁴⁵ A U.S. citizen or resident alien will not be treated as a nonresident with respect to a sale of non-inventory personal property unless an income tax of at least 10% of the gain on the sale is paid to a foreign country.⁴⁶

7. Sales of Inventory. The source of income derived from the sale of inventory property is generally determined by the place where all right, title and interest in the inventory passes to the purchaser.⁴⁷ This general rule of sourcing income, often referred to as the “title-passage” rule, does not apply in cases where (1) inventory is produced within and sold without the United States; (2) inventory is produced without and sold within the U.S.; and (3) inventory is purchased within a U.S. possession and sold within the U.S.⁴⁸

a. Title-Passage Rule. Under the title passage test, a sale of property is generally “consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss.”⁴⁹

⁴³I.R.C. § 865(g)(1)(A).

⁴⁴I.R.C. § 865(a)(2); see Rev. Rul. 91-32, 1991-1 C.B. 107, (“A foreign partner of a partnership that is engaged in a trade or business through a fixed place of business in the United States itself has a fixed place of business in the United States, since the foreign partner is considered to be engaged in such trade or business pursuant to section 875(1). Income from the disposition of a partnership interest by the foreign partner will be attributable to the foreign partner’s fixed place of business in the United States . . . Accordingly, to the extent provided below, income from [a foreign partner’s] disposition of his partnership interest will be sourced in the United States.”) Ann. 91-86, 1991-24 I.R.B. 120; cf. I.R.C. §§ 865(c), 865(d).

⁴⁵I.R.C. § 865(g)(1)(B).

⁴⁶I.R.C. § 865(g)(2).

⁴⁷I.R.C. §§ 865(b), 861(a)(6), 862(a)(6).

⁴⁸I.R.C. § 863(b).

⁴⁹Treas. Reg. § 1.861-7(c); see also *Kates Holding Co. v. Commissioner*, 79 T.C. 700, 706 (1982) (“[T]he country in which personal property is sold is the place where rights, title, and interest pass from seller to buyer, or under certain circumstances, where beneficial ownership and risk of loss pass from seller to buyer.”); *Liggett Group, Inc. v. Commissioner*, 58 T.C.M. (CCH) 1167, 1172 (1990) (“The regulations thus adopt a practical test of locating the point of a sale . . . the seller’s retention of bare legal title will not affect the determination that a sale has taken place, so long as the buyer has assumed the beneficial ownership and risk of loss.”); cf. T.A.M. 200539026 (Sept. 30, 2005) (We consider the case law to be clear that under C.I.F. terms of sale — i.e., where all incidents of ownership pass to the buyer before shipment, but the seller agrees to pay certain costs including insurance against the buyer’s in-transit risk of loss — the sale is consummated at the point of shipment. The difference between the risks insured in a C.I.F. sale and the risk borne by USCorp in this case is that insurance in a C.I.F. sale does not cover the risk of certain in-transit losses such as certain losses due to force majeure, whereas USCorp in this case did bear the risk of in-transit losses due to force majeure. Taxpayer has represented that insurance coverage was commercially available against the type of in-transit risk of loss or damage that it bore with respect to Products during the taxable years at issue. * * * We note that, whereas in a C.I.F. sale risk of loss passes to the buyer at the point of shipment, in this

(1) U.S.-Source Income. If title to an item of “purchased” inventory (as opposed to inventory “produced” by the taxpayer) passes inside of the U.S., then income from the sale of such item of inventory will generally be U.S.-source income.⁵⁰

(2) Foreign-Source Income.

(a) General Rule. If title to an item of “purchased” inventory passes outside of the U.S., then income from the sale will generally be foreign-source income.⁵¹

(b) Exception for Nonresidents. In the case of nonresidents, if title to an inventory item passes outside the U.S., then income from the sale will be U.S.-source income if the gain is attributable to a U.S. office or U.S. fixed place of business of the seller.⁵² This exception does not apply, however, if the inventory is sold for use, disposition, or consumption outside the U.S. and a foreign office or other fixed place of business materially participated in the sale.⁵³

b. Comments Concerning Passage of Title. An understanding of commercial law principles is essential in determining the place where title passes under the “title passage” test. Under conflict-of-law rules, foreign law sometimes may determine title passage in a cross-border sale. If U.S. law applies, however, reference should be made to the Uniform Commercial Code⁵⁴ with respect to passage of title in the commercial context, as well as to common law.⁵⁵

case, certain risk of loss was borne by USCorp during shipment. However, we also observe that, from the point of view of the buyer in both scenarios, risk of casualty loss does not pass to the buyer until delivery at the buyer’s place of business. Thus, the two scenarios may be viewed as economically similar with respect to risk of loss. * * * We conclude that, taking into account the factual similarities between the present case and a C.I.F. case — particularly the economic similarity from the perspective of the buyer — the title passage determination in the present case is governed by the C.I.F. title passage rule case law. Therefore, on the facts described in this memorandum, the sales of Products by USCorp to Distributors are consummated outside the United States.”); F.S.A. 200052002 (Dec. 29, 2000) (analysis of title-passage test). [Footnote omitted.]

⁵⁰I.R.C. §§ 865(b), 861(a)(6); Treas. Reg. § 1.861-7(c).

⁵¹I.R.C. §§ 865(b), 865(e), 862(a)(6).

⁵²I.R.C. §§ 865(b), 865(e)(2)(A), 862(a)(6).

⁵³I.R.C. § 865(e)(2)(B).

⁵⁴State law generally determines the passage of rights and interests between parties, while Federal law determines the effect of these rights and interests on income taxation. *Kates Holding Co. v. Commissioner*, 79 T.C. 700, 706 (1982).

⁵⁵See generally Treasury Department Study, “Report to the Congress on the Sales Source Rules” (January 13, 1993, at L-1 (hereinafter “Treasury Study”). The United States is a party to the “United Nations Convention for the International Sale of Goods,” 19 I.L.M. 671 (the “Sales Convention”), which entered into force for the United States on January 1, 1988. As of January 1, 2002, 62 countries, including Mexico, were signatories to the Sales Convention. U.S. Dep’t of State, *Treaties in Force* (2002).

The Sales Convention generally applies to contracts for the sale of goods between parties whose places of business are in countries that are parties to the Sales Convention. See Sales Convention art. 1(1); Treasury Study at 8. Under Article 6 of the Sales Convention, the parties to a sales contract may exclude the application of the Sales Convention by expressly providing in the sales contracts that the Sales Convention does not apply. Although the Sales

The Uniform Commercial Code generally allows the parties to the sale to agree when and where title will pass, and, absent an agreement, makes title pass upon performance of delivery.⁵⁶ Under the Uniform Commercial Code, where a buyer and seller are located at a considerable distance apart so that the services of a common carrier are required for transportation, title will generally pass either when the seller places the goods aboard the carrier for shipment to the buyer (a “shipment contract”), or when the carrier arrives at the buyer’s location with the goods (a “destination contract”).

By way of example of Texas law on the subject, the last sentence of Section 2.401(a) of the Texas Business and Commerce Code provides that “[s]ubject to these provisions and to the provisions of the chapter on Secured Transactions (Chapter 9), title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties.”⁵⁷ Section 2.401(b) of the Texas Business and Commerce Code provides as follows:

Unless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place; and in particular and despite any reservation of a security interest by the bill of lading

- (1) if the contract requires or authorizes the seller to send the goods to the buyer but does not require him to deliver them at destination, title passes to the buyer at the time and place of shipment; but
- (2) if the contract requires delivery at destination, title passes on tender there.⁵⁸

Parties to a sales transaction can indicate their intent as to title passage. Accordingly, parties to a sales contract should state clearly their intent regarding title passage on contractual documents (for example, order forms, invoices, bills of lading). Often, parties use short-hand terms such as “F.O.B.,” “F.A.S.,” “C.I.F.,” and “Ex-Ship.” These terms are often controlling in determining the source of income. The question of title passage is also influenced by negotiable documents of title which are frequently involved in an international sale. Parties should be familiar with the legal ramifications involved in an international sale and with the legal

Convention does not provide rules for determining title passage, Articles 66 through 70 of the Sales Convention contain rules with respect to the time when the risk of loss passes in a sale transaction.

The Internal Revenue Service has suggested that the Sales Convention is a fairly significant development in the area of U.S. commercial law. The Service has indicated that, in cases where the Sales Convention applies, the Sales Convention rather than state UCC law “is likely to be important in future international title passage issues.” Action on Decision, 1991-03 (February 11, 1991).

⁵⁶See U.C.C. §§ 2-401(1), 2-401(2), 1A U.L.A. (West Supp. 2009).

⁵⁷Tex. Bus. & Com. Code Ann. § 2.401(a) (Vernon Supp. 2012).

⁵⁸Tex. Bus. & Com. Code Ann. § 2.401(b) (Vernon Supp. 2012).

ramifications of, for example, a “bill of lading.” A “bill of lading” is a document of title as well as a contract of shipment and a receipt.

c. Source Rules for Inventory Produced in One Jurisdiction and Sold in Another Jurisdiction. Income from the sale of inventory *produced* or manufactured in one jurisdiction and sold in another jurisdiction is allocated and apportioned between both jurisdictions pursuant to certain allocation and apportionment methods described in the Treasury regulations.⁵⁹

8. Guarantee Income. The Small Business Lending Fund Act of 2010 Small Business Lending Fund Act of 2010⁶⁰ enacted new Section 861(a)(9), which applies to guarantees issued after the date of the enactment of the Act (9/27/2010).⁶¹

a. U.S.-Source Income.

(1) Section 861(a)(9)(A). Under Section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident or a domestic corporation for the provision of a guarantee of any indebtedness of such person.⁶² The legislative history to this section states that the scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness.⁶³ The legislative history also indicates that, for purposes of this provision, the phrase “noncorporate residents” has the same meaning as for purposes of Section 861(a)(1), except that foreign partnerships are not included.⁶⁴

(2) Section 861(a)(9)(B). Under Section 861(a)(9)(B), income from U.S. sources includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. (Payments received from a foreign partnership for the provision of a guarantee of indebtedness of that foreign partnership are U.S. source if the amounts received are connected with income which is effectively connected with the conduct of a U.S. trade or business.⁶⁵) Certain amounts received, whether directly or indirectly, for the provision of a

⁵⁹See I.R.C. § 863(b); Treas. Reg. § 1.863-3.

⁶⁰Pub. L. No. 111-240 (9/27/2010).

⁶¹Pub. L. No. 111-240, § 2122(d).

⁶²I.R.C. § 861(a)(9)(A).

⁶³Joint Committee on Taxation Report [JCX-47-10] (9/16/2010).

⁶⁴Joint Committee on Taxation Report [JCX-47-10] (9/16/2010).

⁶⁵Joint Committee on Taxation Report [JCX-47-10] (9/16/2010).

guarantee are deemed to be effectively connected with the conduct of a U.S. trade or business if derived in the active conduct of a banking, financing or similar business.⁶⁶

b. Foreign-Source Income. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States as determined under Section 861(a)(9).⁶⁷

⁶⁶I.R.C. § 864(c)(4)(B)(ii).

⁶⁷I.R.C. § 862(a)(9).

CHAPTER III: U.S. TRADE OR BUSINESS STATUS OF FOREIGN PERSONS IN THE UNITED STATES

A. What Is the Significance of a Nonresident Alien or Foreign Corporation Engaging in a U.S. Trade or Business? The method and rate of taxation of the U.S.-source income of a nonresident alien and foreign corporation generally depends upon whether or not the taxpayer is engaged in a trade or business in the U.S. and whether the item of income is effectively connected with the conduct of that trade or business.

B. How Is “Trade or Business” Status Determined?

1. Relevant Factors in Determining Trade or Business Status. The existence of a U.S. trade or business is generally determined on a case-by-case basis.⁶⁸ The question of whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law.⁶⁹ Several factors are considered in determining “trade or business” status, including the following:

- a. Continuity and regularity of activity;
- b. Presence of personnel with discretionary authority;
- c. Significance of activity in producing income;

⁶⁸See Rev. Rul. 88-3, 1988-1 C.B. 268 (“[T]he determination whether a taxpayer is engaged in a trade or business within the United States is highly factual. Such a determination is not ordinarily made in an advance ruling.”).

⁶⁹See, e.g., *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff’d*, 281 F.2d 646 (6th Cir. 1960); *Consolidated Premium Iron Ores, Ltd. v. Commissioner*, 28 T.C. 127, 150-52 (1957) (suggesting that “engaged in business” conveys the idea of “progression, continuity, or sustained activity”), *aff’d*, 265 F.2d 320 (6th Cir. 1959); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959) *cert. denied*, 361 U.S. 827 (1959); *European Naval Stores Co., S.A. v. Commissioner*, 11 T.C. 127, 133 (1948) (suggesting that “engaged in business” conveys the idea of “progression, continuity, or sustained activity”); *Linen Thread Co., Ltd. v. Commissioner*, 14 T.C. 725, 736 (1950) (“The character of [the American] office and the purpose for which that office was established are determinative of whether petitioner was engaged in trade or business within the United States.”); *Scottish American Inv. Co. v. Commissioner*, 12 T.C. 49, 59 (1949) (“In cases such as these, it is a matter of degree, based upon both a quantitative and a qualitative analysis of the services performed, as to where the line of demarcation should be drawn. It is not so much the volume of the activities of the Jersey City office, although volume of activities may, in some cases, be a factor, but rather their character and the purpose for which the office is established that we believe are determinative.”); *Perez v. Commissioner*, 56 T.C.M. (CCH) 312, 317 (1988) (“A foreign taxpayer is engaged in a trade or business within the United States if the taxpayer, continuously and regularly, transacts a substantial portion of its ordinary business within the United States during a substantial portion of the taxable year . . . The term ‘engaged in a trade or business’ has been interpreted to mean ‘doing business’ which conveys the idea of a continued and sustained activity.”); *Inverworld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, 3237-30 (1996) (“[W]e conclude that [the foreign taxpayer] ‘engaged in *** substantial, regular, or continuous ordinary business activity in the United States.’”). For an excellent article analyzing the term “trade or business” from the standpoint of the foreign person, see Isenbergh, *The “Trade or Business” of Foreign Taxpayers in the United States*, 61 Taxes 972 (1983); see also Kadet and Koontz, “Profit-Shifting Structures and Unexpected Partnership Status,” 2016 TNT 75-11 (“The purpose of this report is to illustrate that in many situations when the three factors exist, there will also be joint activities and other conditions that create a separate entity treated as a partnership for U.S. tax purposes, with the partners being the foreign and U.S. group members involved in the applicable business.”).

- d. Nature and function of U.S. facilities and personnel; and
- e. Number of transactions completed in the U.S.

2. Activities of Agent Attributed to Nonresident Alien or Foreign Corporation. The U.S. activities of a nonresident alien or foreign corporation's dependent agent in the U.S. will be attributed to the nonresident alien or foreign corporation in determining whether or not the nonresident alien or foreign corporation is conducting a trade or business in the U.S.⁷⁰ A nonresident alien or foreign corporation that is a partner in a partnership or a beneficiary of an estate or trust is treated as engaged in the conduct of a trade or business in the United States if the partnership, estate or trust is so engaged.⁷¹

3. Trade or Business Includes Performance of Personal Services in the U.S. The Code contains specific rules with respect to the application of the trade or business standard to certain activities. For example, trade or business within the United States expressly includes the performance of personal services within the United States.⁷² An exception applies, however, in the case of a nonresident alien individual's performance of services for a foreign employer, where the total compensation received for such services during the year is \$3,000 or less and the period in which the individual is present in the U.S. does not exceed 90 days.⁷³

4. Special Rules Apply to Trading in Stocks or Securities. Detailed rules govern the determination of whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.⁷⁴

⁷⁰*Cf. Taisei Fire & Marine Ins. Co., Ltd. v. Commissioner*, 104 T.C. 535, 554 (1995), *acq.* 1995-2 C.B. 1, (case addresses whether agent qualified as an "independent agent" under U.S./Japan Income Tax Treaty); *see generally* Hannes, "Achieving Transfer Pricing Objectives Without Creating a U.S. Business for a Foreign Person," 2003 TNT 92-57 (May 9, 2003) (article explores the federal source-basis income tax ramifications when a foreign supplier distributes goods in the United States through a U.S. corporation and the foreign supplier protects the U.S. corporation against financial risks).

⁷¹I.R.C. § 875.

⁷²I.R.C. § 864(b)(1).

⁷³I.R.C. § 864(b)(1).

⁷⁴I.R.C. § 864(b)(2); *cf. I.L.M.* 201501013 (Sept. 5, 2014) ("Based on all the facts and circumstances described above, Fund, through Fund Manager, engaged in lending and stock distribution activities within the United States on a considerable, continuous, and regular basis. Those activities were neither investment activities, nor "trading in stock and securities" as that term is used in the Trading Safe Harbors. Rather, Fund's extensive lending and underwriting activities caused Fund to be engaged in a trade or business within the United States during Year 1 and Year 2. As a partner in Fund, Foreign Feeder was engaged in a trade or business within the United States."); *see* "Cayman Islands Investment Fund Challenges FPAA's in Tax Court," 2015 WTD 125-22; *see generally* Sheppard and Davis, "News Analysis: Securities Trading Safe Harbor Going Before U.S. Tax Court."), 2015 WTD 130-1.

CHAPTER IV: EFFECTIVELY CONNECTED INCOME

A. The Significance of Effectively Connected Income. A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is “effectively connected” with such business.⁷⁵

B. Rules Governing the Determination of Whether Income is Effectively Connected. Specific statutory rules govern the determination of whether income is effectively connected.⁷⁶

1. U.S.-Source Income. In determining whether income is effectively connected with the conduct of a U.S. trade or business, “income from sources within the United States generally is segregated between two categories, pursuant to section 864(c)(2) and (3).”⁷⁷ The first category consists of U.S.-source capital gain or loss and U.S.-source income subject to gross-basis taxation. The second category consists of all other U.S.-source income.

a. U.S.-Source Capital Gain or Loss and U.S.-Source Income Subject to Gross-Basis Taxation. In the case of U.S.-source capital gain or loss and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, “[s]ection 864(c)(2) provides two general ‘factors’ to consider in determining whether income from sources within the United States falling under its purview is effectively connected:”⁷⁸ (1) the amount is derived from assets used in or held for use in the conduct of the U.S. trade or business (the “asset-use test”); and (2) the activities of the trade or business were a material factor in the realization of the amount (the “business-activities test”).⁷⁹ Additionally, in determining whether income is effectively connected with a U.S. trade or business, due regard is given to whether the asset or income, gain or loss was accounted for through the U.S. trade or business.⁸⁰

⁷⁵I.R.C. § 882(a)(1); cf. PLR. 201228013 (Apr. 17, 2012) (“[I]t is held that: 1) The portion of Taxpayer’s unused net operating losses from Business X that were generated while he was taxed as a U.S. resident, and that would have been allocated and apportioned, in accordance with the rules in Treas. Reg. § 1.8618(e)(8), to the gross income of Business X had he been taxed on such income as a nonresident alien for such years, may be used to the extent provided in Treas. Reg. § 1.861-8 to offset gross income effectively connected with the conduct of Business X in the United States while he is a nonresident alien. 2) Taxpayer may carry over any unused net operating losses from Business X allocated and apportioned to income effectively connected with the conduct of Business X in the United States while he is taxed as a nonresident alien, and may apply such losses against gross income from Business X after he reacquires U.S. resident status. 3) Taxpayer may carry over any unused net operating losses from Business X generated while he was taxed as a U.S. resident, if still available, against his gross income after he reacquires U.S. resident status. The years in which Taxpayer is a nonresident alien will be taken into account in determining whether any such unused net operating losses from Business X are still available under section 172(b)(1).”).

⁷⁶I.R.C. § 864(c).

⁷⁷*Inverworld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, 3237-36 (1996).

⁷⁸*Ibid.*

⁷⁹I.R.C. § 864(c)(2); see Rev. Rul. 91-32, 1991-1 C.B. 107 (“Gain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source ECI gain or will be ECI loss that is allocable to United States source ECI gain, to the extent that the partner’s distributive share of unrealized gain or loss of the partnership would be attributable to ECI (United States source) property of the partnership.”) *corrected by* Ann. 91-86, 1991-24 I.R.B. 120; see also Treas. Reg. § 1.864-4(c)(5) (“Special rules relating to banking, financing, or similar business activity.”).

⁸⁰I.R.C. § 864(c)(2).

(1) Asset-Use Test. The asset-use test ordinarily applies “in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss.”⁸¹ The regulations state that the test is “of primary significance where, for example, interest or dividend income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States.”⁸²

(2) Business-Activities Test. The business activities test ordinarily applies in “making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer’s trade or business in the United States.”⁸³ The regulations provide that the business-activities test is of primary significance in cases in which: (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business.⁸⁴

b. All Other U.S.-Source Income. In the case of any other U.S. - source income, gain, or loss (not otherwise included above), such amounts are all treated as effectively connected with the conduct of the trade or business in the United States.⁸⁵

2. Foreign-Source Income. Certain prescribed types of foreign-source income of a foreign person may be taxed by the U.S. if the income is effectively connected with the conduct of a trade or business in the United States.⁸⁶ Foreign-source income, gain, or loss generally is considered to be effectively connected with a U. S. business only if the person has an office or other fixed place of business within the United States⁸⁷ to which such income, gain, or loss is attributable and such income falls into one of the following three categories:⁸⁸

⁸¹Treas. Reg. § 1.864-4(c)(2)(i).

⁸²Treas. Reg. § 1.864-4(c)(2)(i).

⁸³Treas. Reg. § 1.864-4(c)(3)(i).

⁸⁴Treas. Reg. § 1.864-4(c)(3)(i).

⁸⁵I.R.C. § 864(c)(3).

⁸⁶I.R.C. § 864(c)(4)(B); *see also* I.R.C. § 906(a) (allowing credit for foreign income taxes paid or accrued with respect to income effectively connected with the conduct of a trade or business within the United States).

⁸⁷*See* I.R.C. § 864(c)(4) (special rules for use in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business in the U.S. and whether income and to what extent income, gain or loss is attributable to an office or other fixed place of business in the U.S.).

⁸⁸I.R.C. § 864(c)(4)(B); *see also* I.R.C. § 864(c)(4)(C) (special rules apply for purposes of determining the effectively-connected income of an insurance company).

a. Rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or business;⁸⁹

b. Interest, dividends or amounts received for the provision of guarantees of indebtedness derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account;⁹⁰

c. Income, gain, or loss derived from the sale or exchange (outside the U.S.) of inventory or property held primarily for sale to customers in the ordinary course of business where the sale or exchange was made through the foreign person's U.S. office or other fixed place of business.⁹¹ Such amounts, however, are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale or exchange.⁹²

Foreign-source income of a type not specified above generally is not subject to U.S. federal income tax.⁹³

3. Treatment of Deferred Payments. Income, gain, or loss for a particular year generally is not treated as effectively connected if the foreign person is not engaged in a U.S. trade or business in that year.⁹⁴ If, however, income or gain taken into account for a tax year is attributable to the sale or exchange of property, the performance of services, or any other transaction which occurred in a prior taxable year, the determination whether such income or gain is taxable on a net basis is required to be made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.⁹⁵

4. Special Treatment of Certain Property Transactions. If any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis is required to be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or

⁸⁹I.R.C. § 864(c)(4)(B)(i); *but see* I.R.C. § 864(c)(4)(D)(limited exception applies to foreign source income if it either (i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the total voting stock or (ii) is Subpart F income).

⁹⁰I.R.C. § 864(c)(4)(B)(ii); *but see* I.R.C. § 864(c)(4)(D)(limited exception applies to foreign source income if it either (i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the total voting stock or (ii) is Subpart F income).

⁹¹I.R.C. § 864(c)(4)(B)(iii).

⁹²I.R.C. § 864(c)(4)(B)(iii).

⁹³I.R.C. § 864(c)(4)(A).

⁹⁴I.R.C. § 864(c)(1)(B).

⁹⁵I.R.C. § 864(c)(6).

business in the U.S. and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account.⁹⁶

⁹⁶I.R.C. § 864(c)(7).

CHAPTER V: CLASSIFICATION OF INDIVIDUALS AND ENTITIES FOR U.S. FEDERAL INCOME TAX PURPOSES

A. Definition of Nonresident Alien for U.S. Federal Income Tax Purposes.

1. Nonresident Alien is an Individual Who is Neither a U.S. Citizen Nor a U.S. Resident. For U.S. federal income tax purposes, a “nonresident alien” is an individual who is neither a U.S. citizen nor a U.S. resident.⁹⁷

a. Determining Residency of an Individual for U.S. Income Tax Purposes. An alien individual is treated as a U.S. resident with respect to any calendar year if (and only if) such individual either:

(1) Is a lawful permanent resident of the U.S. at any time during the calendar year (the “green card test”); or

(2) Such individual meets a “substantial presence test.”⁹⁸

b. The Green Card Test. A lawful permanent resident is an individual who has been granted the privilege of residing permanently in the U.S. as an immigrant under U.S. immigration laws.⁹⁹ The test is called the “green card test” because lawful permanent residence is evidenced by possession of a U.S. Immigration and Naturalization Service Form I-151 or I-551 (Alien Registration Receipt Card, commonly called a “green card”).

c. The Substantial Presence Test.

(1) **General Rule.** An individual meets the “substantial presence test” if:

(a) Such individual is physically present in the U.S. for 31 days during the current calendar year; and

(b) The sum of the following equals or exceeds 183 days:

i) the number of days that the nonresident alien is present in the U.S. during the current calendar year; plus

ii) 1/3 of the days in the first preceding calendar year; plus

⁹⁷I.R.C. § 7701(b)(1)(B).

⁹⁸I.R.C. § 7701(b)(1)(A).

⁹⁹I.R.C. § 7701(b)(1)(A)(i).

include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation.¹⁰⁶ A corporation is defined to include associations, joint-stock companies, and insurance companies.¹⁰⁷

2. Final Check-The-Box Regulations. On December 17, 1996, the IRS adopted final entity classification changes (known as the “check-the-box regulations”), generally effective as of January 1, 1997.¹⁰⁸ Under the prior regulations, the classification of an unincorporated organization as a partnership or a corporation depended on whether the entity had a majority of certain prescribed corporate characteristics.¹⁰⁹ The check-the-box regulations replaced these rules with a four-step process for classifying an entity for federal tax purposes.

3. Step One: Determine Whether a Separate Entity Exists for Federal Tax Purposes. The first step in the check-the-box classification process is to determine whether there is a separate entity for federal tax purposes (which is a matter of federal tax law).¹¹⁰

(1) Federal Tax Law Controls Whether Entity Is Separate from Owners. The issue of whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.¹¹¹

(2) Certain Joint Undertakings May Constitute Separate Entities for Tax Purposes. The check-the-box regulations retain the pre-check-the-box rules regarding joint undertakings. Certain joint undertakings that are not entities under local law may nonetheless constitute separate entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the individuals actively carry on a trade, business, financial operation, or venture and divide the profits therefrom.¹¹² For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent; however, a joint undertaking “merely to share expenses” does not create a separate entity.¹¹³ The regulations state that a separate entity would not exist for federal tax purposes if two or more persons jointly constructing a ditch merely to drain surface water from their properties. As another example, the regulations provide that “mere co-ownership of

¹⁰⁶I.R.C. § 7701(a)(2).

¹⁰⁷I.R.C. § 7701(a)(3).

¹⁰⁸Treas. Reg. §§ 301.7701-1(f), 301.7701-2(e), 301.7701-3(f)(1).

¹⁰⁹Former Treas. Reg. §§ 301.7701-2 and -3; *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-2 C.B.1.

¹¹⁰T.D. 8697, 1997-2 I.R.B. 12; Notice of Proposed Rulemaking, PS-43-95, 1996-1 C.B. 865, 866 [hereinafter “Reg. Notice”].

¹¹¹Treas. Reg. § 301.7701-1(a)(1).

¹¹²Treas. Reg. § 301.7701-1(a)(2).

¹¹³Treas. Reg. § 301.7701-1(a)(2).

property” that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.¹¹⁴

(3) Certain Single-Owner Organizations Can Choose Whether to be Recognized. Under the check-the-box regulations, certain organizations (discussed below) that have a single owner can choose to be recognized or disregarded as entities separate from their owners.¹¹⁵ If an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.¹¹⁶

4. Step Two: If a Separate Entity Exists, Determine Whether the Entity Is a Trust or a Business Entity. The regulations provide that an organization that is recognized as a separate entity for federal tax purposes is either a trust or a “business entity” (unless a provision of the Code expressly provides for special treatment, such as the real estate mortgage investment conduit rules). Thus, the second step in the classification process is to determine whether a separate entity for federal tax purposes is a trust or a “business entity.” A “business entity” is defined in the regulations as “any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner . . .) that is not properly classified as a trust . . . or otherwise subject to special treatment under the Internal Revenue Code.”¹¹⁷ The classification of organizations as trusts is governed by Treas. Reg. § 301.7701-4. That section restates the distinction between trusts and business entities that existed prior to the issuance of the check-the-box regulations. The check-the-box regulations were not intended to change the pre-check-the-box rules for determining whether an organization is classified as a trust for federal tax purposes.¹¹⁸

5. Step Three: If an Entity Is a Business Entity, Determine Whether It Is Automatically Classified as a Corporation. If an entity is a business entity, the third step in the classification process is to determine whether it is automatically classified as a corporation.¹¹⁹ Treas. Reg. § 301.7701-2 specifies eight types of business entities that are automatically classified as corporations for federal tax purposes and also prescribes certain special rules applicable to foreign entities. The eight types of entities that are automatically classified as corporations are as follows:

¹¹⁴Treas. Reg. § 301.7701-1(a)(2); *see also* Rev. Proc. 2002-22, 2002-1 C.B. 733 modified by Rev. Proc. 2003-3, 2003-1 C.B. 113 (specifies conditions under which the Revenue Service will consider a request for ruling that an undivided fractional interest in rental real property is not an interest in a business entity).

¹¹⁵Treas. Reg. § 301.7701-1(a)(4).

¹¹⁶Treas. Reg. § 301.7701-2(a).

¹¹⁷Treas. Reg. § 301.7701-2(a).

¹¹⁸*See* T.D. 8697, 1997-2 I.R.B. 12; Reg. Notice, 1996-1 C.B. at 866; *cf.* PLR. 201245003 (July 30, 2012) (“The [Mexican Land Trust] described here is similar to an Illinois Land Trust. The sole purpose of the MLT is to satisfy the Mexican Federal Constitution by vesting legal title to the property in the name of the trustee. The trustee’s sole responsibility for the property is to hold and transfer title at the exclusive direction of the taxpayer. The trustee has no duty and no right to defend, maintain, or manage the property. Taxpayer retains sole authority to manage and control the property, the direct right to collect any rents or proceeds generated by the property, and the direct obligation to pay all taxes and liabilities related to the property. We also note that there is no arrangement between Bank, X, A, B or any other person to utilize the condominium in an activity for profit, such that ownership of the condominium could be classified as a business entity.”).

¹¹⁹*See* Treas. Reg. § 301.7701-3(a); Reg. Notice, 1996-1 C.B. at 866.

(1) A business entity organized under a Federal or State statute (or under a statute of a federally recognized Indian tribe) describing or referring to the entity as incorporated or as a corporation, body corporate, or body politic;¹²⁰

(2) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;¹²¹

(3) An insurance company;¹²²

(4) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended,¹²³ or a similar federal statute;¹²⁴

(5) A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or certain integral parts or controlled entities of a foreign sovereign;¹²⁵

(6) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3),¹²⁶ including a business entity that is publicly traded within the meaning of section 7704 (and not within the exception in section 7704(c)) and a business entity that is a taxable mortgage pool under section 7701(i);¹²⁷

(7) An entity created or organized under the laws of more than one jurisdiction if the check-the-box rules would treat it as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized;¹²⁸ and

(8) Certain foreign entities listed in the regulations, including the following:¹²⁹

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company

¹²⁰Treas. Reg. § 301.7701-2(b)(1); Reg. Notice, 1996-1 C.B. at 866-67.

¹²¹Treas. Reg. § 301.7701-2(b)(3).

¹²²Treas. Reg. § 301.7701-2(b)(4).

¹²³12 U.S.C. § 1811.

¹²⁴Treas. Reg. § 301.7701-2(b)(5).

¹²⁵Treas. Reg. § 301.7701-2(b)(6); see Treas. Reg. § 1.892-2T.

¹²⁶Treas. Reg. § 301.7701-2(b)(7).

¹²⁷Reg. Notice, 1996-1 C.B. at 867.

¹²⁸Temp. Treas. Reg. § 301.7701-2(b)(9).

¹²⁹Treas. Reg. § 301.7701-2(b)(8).

Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Bulgaria, Aktsionerno Druzhestvo.
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost
Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Estonia, Aktsiaselts
European Economic Area/European Union, Societas Europaea
Finland, Julkinen Osakeyhtio/Publikt Aktiebolag
France, Societe Anonyme
Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company
Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag
Iceland, Hlutfelag
India, Public Limited Company
Indonesia, Perseroan Terbuka
Ireland, Public Limited Company
Israel, Public Limited Company
Italy, Societa per Azioni
Jamaica, Public Limited Company
Japan, Kabushiki Kaisha
Kazakhstan, Ashyk Aktsionerlik Kogham
Republic of Korea, Chusik Hoesa
Latvia, Akciju Sabiedriba
Liberia, Corporation
Liechtenstein, Aktiengesellschaft
Lithuania, Akcine Bendroves
Luxembourg, Societe Anonyme
Malaysia, Berhad
Malta, Public Limited Company
Mexico, Sociedad Anonima
Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap
New Zealand, Limited Company
Nicaragua, Compania Anonima
Nigeria, Public Limited Company
Northern Mariana Islands, Corporation
Norway, Allment Aksjeselskap
Pakistan, Public Limited Company
Panama, Sociedad Anonima
Paraguay, Sociedad Anonima
Peru, Sociedad Anonima
Philippines, Stock Corporation
Poland, Spolka Akcyjna
Portugal, Sociedade Anonima
Puerto Rico, Corporation
Romania, Societe pe Actiuni
Russia, Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia, Sharikat Al-Mossahamah
Singapore, Public Limited Company
Slovak Republic, Akciova Spolocnost
Slovenia, Delniska Druzba
South Africa, Public Limited Company
Spain, Sociedad Anonima
Surinam, Naamloze Vennootschap
Sweden, Publika Aktiebolag
Switzerland, Aktiengesellschaft
Thailand, Borisat Chamkad (Mahachon)
Trinidad and Tobago, Limited Company
Tunisia, Societe Anonyme
Turkey, Anonim Sirket
Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom, Public Limited Company
United States Virgin Islands, Corporation
Uruguay, Sociedad Anonima
Venezuela, Sociedad Anonima or Compania Anonima

6. Step Four: If an Entity Is a Business Entity and Is Not Automatically Classified as a Corporation, Classify the Entity According to the Regulations. If an entity is a business entity and is not automatically classifiable as a corporation, such an entity (referred to as an “eligible entity” in the regulations) may elect its classification for federal tax purposes.¹³⁰

(1) General Classification Rules. An eligible entity with two or more members may elect to be classified as a corporation or a partnership.¹³¹ An eligible entity with a single member may elect to be classified as a corporation or to be “disregarded” as

¹³⁰See Treas. Reg. § 301-7701-3.

¹³¹Treas. Reg. § 301.7701-3(a).

an entity separate from its owner.¹³² (Certain special rules apply to banks.¹³³) A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation.¹³⁴ The Regulations provide a default classification for an eligible entity that does not make an election.¹³⁵ Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification.¹³⁶

(2) Default Classification Rules (For Eligible Entities That Do Not File an Election).

(a) Domestic Eligible Entities. For domestic eligible entities formed on or after January 1, 1997, the default rules are as follows: (1) a domestic entity with two or more members is classified as a partnership;¹³⁷ and (2) a domestic single-member eligible entity is disregarded as separate from its owner.¹³⁸ For domestic eligible entities in existence prior to January 1, 1997, the default classification is generally the classification claimed by the entity under the pre-check-the-box regulations¹³⁹ subject to a special rule for single-member entities. Single-member entities that claimed to be a partnership under the pre-check-the-box regulations are treated as disregarded entities.¹⁴⁰

Revenue Procedure 2002-69 provides guidance on the classification of a “qualified entity” that is owned by a husband and wife as community property under the laws of a U.S. state, a foreign country or a possession of the United States.¹⁴¹ A business entity is a qualified entity if: (1) the business entity is wholly owned by a husband and wife as community property under the laws of a U.S. state, a foreign country, or a U.S. possession; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the business entity is not treated as a corporation under the check-the-box regulations.¹⁴² The Revenue Procedure provides that: (1) if a qualified entity, and the husband and wife, as community property owners, treat the entity as a disregarded entity for federal tax purposes, the Internal Revenue Service will accept the position that the entity is a disregarded entity for federal tax

¹³²Treas. Reg. §§ 301.7701-3(a), 301.7701-2(b)(2).

¹³³See Treas. Reg. § 301.7701-2(c)(2)(ii).

¹³⁴Treas. Reg. § 301.7701-2(a).

¹³⁵Treas. Reg. Sec. 301.7701-3(a).

¹³⁶Treas. Reg. Sec. 301.7701-3(a).

¹³⁷Treas. Reg. § 301.7701-3(b)(1)(i).

¹³⁸Treas. Reg. § 301.7701-3(b)(1)(ii); *but cf.* Treas. Reg. § 301.7701-2T(c)(2)(iii)(A) (“An entity that is disregarded as separate from its owner for any purpose under § 301.7701-2 is treated as an entity separate from its owner for purposes of (1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded; (2) Federal tax liabilities of any other entity for which the entity is liable. (3) refunds or credits of Federal tax.”).

¹³⁹Treas. Reg. § 301.7701-3(b)(3)(i).

¹⁴⁰Treas. Reg. § 301.7701-3(b)(3)(i).

¹⁴¹Rev. Proc. 2002-69, § 1, 2002-44 I.R.B. 1 (Oct. 9, 2002).

¹⁴²Rev. Proc. 2002-69, § 3.02.

purposes;¹⁴³ (2) if a qualified entity, and the husband and wife as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the Internal Revenue Service will accept the position that the entity is a partnership for federal tax purposes;¹⁴⁴ and (3) a change in reporting position will be treated for federal tax purposes as a conversion of the entity.¹⁴⁵

(b) Foreign Eligible Entities. For foreign eligible entities formed on or after January 1, 1997, unless the entity elects otherwise, a foreign eligible entity is (1) a partnership if it has two or more members and at least one member does not have limited liability; (2) a corporation if all members have limited liability; (3) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.¹⁴⁶ For foreign eligible entities in existence prior to January 1, 1997, the default classification is generally the classification claimed by the entity under the pre-check-the-box regulations¹⁴⁷ subject to a special rule for single-member entities. Single-member entities that claimed to be a partnership under the pre-check-the-box regulations are treated as disregarded entities.¹⁴⁸ A foreign eligible entity is treated as being in existence prior to January 1, 1997, only if the entity's classification was relevant at any time during the 60 months prior to January 1, 1997.¹⁴⁹ The regulations provide special rules for determining the relevancy of an entity's classification.¹⁵⁰

(3) Procedural Rules for Filing Election. The Treasury regulations prescribe the procedure for filing an election to classify an eligible entity.¹⁵¹ An eligible entity makes a classification election by filing Form 8832 with the Internal Revenue Service.¹⁵² The regulations provide that "[a]n election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832."¹⁵³ An entity may file its initial election at any time, but the regulations generally prohibit filing of more than one election to change an entity's classification during any 60-month period.¹⁵⁴ An election is effective on the date specified on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 cannot be more than 75 days prior to the date on which the election is filed and cannot be more than 12 months after the election is filed.¹⁵⁵

¹⁴³Rev. Proc. 2002-69, § 4.01.

¹⁴⁴Rev. Proc. 2002-69, § 4.02.

¹⁴⁵Rev. Proc. 2002-69, § 4.03.

¹⁴⁶Treas. Reg. § 301.7701-3(b)(2).

¹⁴⁷Treas. Reg. § 301.7701-3(b)(3)(i).

¹⁴⁸Treas. Reg. § 301.7701-3(b)(3)(i).

¹⁴⁹Treas. Reg. § 301.7701-3(b)(ii).

¹⁵⁰Treas. Reg. § 301.7701-3(d)(1).

¹⁵¹Treas. Reg. § 301.7701-3(c).

¹⁵²Treas. Reg. § 301.7701-3(c)(1)(i).

¹⁵³Treas. Reg. § 301.7701-3(c)(1)(i).

¹⁵⁴Treas. Reg. § 301.7701-3(c)(1)(iv).

¹⁵⁵Treas. Reg. § 301.7701-3(c)(1)(iii). The Procedure and Administration regulations permit the Service to grant a reasonable extension of time for making certain elections, including the entity classification election on Form 8832. Treas. Reg. § 301.9100-1(c). Under these regulations, an extension of time to file certain elections will be granted if

7. Elective Changes in Classification. The Treasury regulations prescribe the deemed federal income tax consequences of the following elective changes in classification: (1) partnership to corporation; (2) corporation to partnership; (3) corporation to disregarded entity; and (4) disregarded entity to a corporation.¹⁵⁶

8. Revenue Ruling 2004-77. In Revenue Ruling 2004-77, the Revenue Service considers the federal income tax classification of a limited partnership (LP) that consists of a limited liability company (L) as general partner and a corporation (X) as limited partner. X is the sole owner of L and L is disregarded as an entity separate from X and L's activities are treated in the same manner as a branch or division of X. The Ruling concludes that, for federal tax purposes, LP is disregarded as an entity separate from its owner, X. The Ruling states that because L is disregarded as an entity separate from X, X is treated as owning all of the interests in LP. LP is a domestic entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because LP has only one owner for federal tax purposes, LP cannot be classified as a partnership.

9. Administrative Dissolution. The Revenue Service has concluded in several relatively recent private letter rulings that if the affairs of a corporation continue after the expiration of its state charter, or the termination of its existence, it becomes an association and continues to be classified as a corporation.¹⁵⁷ In Private Letter Ruling 200539005 (June 17, 2005), the Revenue Service, citing *Ochs v. United States*,¹⁵⁸ stated that "[i]f the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association." The Service stated that a corporation is subject to federal corporate income tax liability as long as it continues to do business in a corporate manner, despite the fact that its recognized legal status under state law is terminated.¹⁵⁹ In Private Letter Ruling 200114029, the Service held that the administrative dissolution of a corporation, the subsequent reincorporation that followed and the new corporation's succession to its assets and business (1) did not affect the corporation's S corporation election; (2) did not result in a distribution for purposes of Sections 301, 311, or 336, (3) the formation of the new corporation and its succession to the administratively dissolved corporation's business was not a transaction subject to Section 351 of the Code; (4) the dissolution and subsequent reincorporation of the

the taxpayer is able to establish that it acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. Treas. Reg. § 301.9100-3. See, e.g., PLR 200318061 (May 2, 2003); PLR 200316029 (April 18, 2003); PLR 200306006 (Feb. 7, 2003). Private letter rulings are not binding as "precedent," but they often represent a substantial indication of the position of the Revenue Service on an issue.

¹⁵⁶Treas. Reg. § 301.7701-3(g); see also Rev. Rul. 2004-59, 2004-24 IRB 1050 ("If an unincorporated state law entity that is classified as a partnership for federal tax purposes converts into a state law corporation under a state law formless conversion statute, the following is deemed to occur: the partnership contributes all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners.").

¹⁵⁷See, e.g., PLR 200616002 (April 21, 2006); PLR 200539005 (June 17, 2005); PLR 200535017 (Sept. 2, 2005); PLR 200315020 (Apr. 11, 2003); PLR 200252033 (Dec. 27, 2002); PLR 200123058 (June 8, 2001); PLR 200114029 (Apr. 4, 2001).

¹⁵⁸305 F.2d 844, 847 (Ct.Cl. 1962), cert. denied, 372 U.S. 968 (1963).

¹⁵⁹See also PLR 200123058 (June 11, 2001); PLR 200114029 (Apr. 4, 2001).

corporation did not effect the bases or holding period of the shareholders' stock; and (5) the new corporation need not apply for a new employer identification number.¹⁶⁰

C. Foreign Corporation. A foreign corporation is a corporation created or organized outside of the U.S.¹⁶¹

D. Foreign Trust. A foreign trust is any trust other than a U.S. trust. A U.S. trust is any trust if (i) a U.S. court is able to exercise primary jurisdiction over the administration of the trust; and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.¹⁶²

¹⁶⁰PLR 200114029 (Apr. 6, 2001).

¹⁶¹I.R.C. §§ 7701(a)(4) and (5).

¹⁶²I.R.C. §§ 7701(a)(31), 7701(a)(30). The Small Business Job Protection Act of 1996 made several changes to the U.S. federal income tax rules applicable to foreign trusts. One significant change is the enactment of new Section 672(f). That section generally applies the grantor trust rules only to the extent such application results, directly or indirectly, in income or other amounts (if any) being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Certain exceptions to this general rule are set forth in I.R.C. § 672(f)(2).

CHAPTER VI: 2008 EXPATRIATION LEGISLATION.

In 2008, Congress enacted new section 877A. It applies to “covered expatriates” whose “expatriation date” is on or after June 17, 2008.¹⁶³ Section 877A supersedes the existing expatriation rules.

A. General Operation of Section 877A and Section 2801. Section 877A(a)(1) provides that “[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.”¹⁶⁴ The “expatriation date” is the date an individual relinquishes U.S. citizenship or, in the case of a long-term resident, the date on which the individual ceases to be a lawful permanent resident of the United States for U.S. immigration law purposes.¹⁶⁵ Gain from the deemed sale is taken into account for the tax year of the deemed sale date without regard to other provisions of U.S. income tax law.¹⁶⁶ Any loss from the deemed sale generally is taken into account to the extent otherwise provided by U.S. tax income tax laws (with a limited exception for certain wash sales).¹⁶⁷ Thus, Section 877A subjects covered expatriates to U.S. income tax on the net unrealized gain on all of their property as if the property had been sold for its fair market value on the day before their residency termination date.¹⁶⁸ Gain recognized on the deemed sale is reduced, however (but not below zero), by \$600,000¹⁶⁹ (increased for a cost of living adjustment factor for calendar years after 2008 -- \$693,000 in 2016¹⁷⁰). Any gains or losses subsequently realized are to be adjusted for gains and losses taken into account under the deemed sale rules, without regard to the \$600,000 exemption.¹⁷¹

The new legislation also imposes a transfer tax on certain transfers to U.S. persons from covered expatriates, or from their estates.¹⁷²

B. Property Subject to the Deemed Sale Rules of Section 877A. Section 877A applies to most types of property interests held by the covered expatriate on the date of termination of residency, with certain exceptions.¹⁷³ Deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts are not subject to the deemed sale rule described above, but are subject to other special rules.¹⁷⁴

C. Application of Section 877A. Section 877A applies to an individual relinquishing U.S. citizenship or to a “long-term resident” terminating U.S. residency, if such individual (1) has an average annual net income tax liability for the five preceding years ending

¹⁶³Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624-1650.

¹⁶⁴See *Topsnick v. Commissioner*, 146 T.C. No. 1 (2016).

¹⁶⁵I.R.C. § 877A(g)(3); I.R.C. § 7701(b)(6).

¹⁶⁶I.R.C. § 877A(a)(2)(A).

¹⁶⁷I.R.C. § 877A(a)(2)(B).

¹⁶⁸I.R.C. § 877A(a)(1).

¹⁶⁹I.R.C. § 877A(a)(3)(A).

¹⁷⁰I.R.C. § 877A(a)(3)(B)(i); Rev. Proc. 2015-53, § 3.31, 2015-44 I.R.B. 615.

¹⁷¹I.R.C. § 877A(a).

¹⁷²I.R.C. § 2801.

¹⁷³See I.R.C. §§ 877A(a)(1), 877A(c).

¹⁷⁴See I.R.C. §§ 877A(c), 877(d), 877(e), 877A(f).

before the date of the loss of U.S. citizenship or the residency termination that exceeds \$124,000 (as adjusted for inflation¹⁷⁵ - \$161,000 in 2016¹⁷⁶); (2) has a net worth of \$2 million or more on such date; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.¹⁷⁷ Certain exceptions apply.¹⁷⁸

A long-term resident is defined as an individual who had lawful permanent status under the U.S. immigration laws (i.e., held a greencard that has not been revoked and that has not been administratively or judicially determined to have been abandoned¹⁷⁹) in at least 8 tax years during a period of 15 tax years ending in the year the greencard is relinquished.¹⁸⁰ An individual is considered a lawful permanent resident in a tax year if he or she is a lawful permanent resident during any portion of that year.¹⁸¹ The IRS has promulgated guidance regarding Section 877A in Notice 2009-85.¹⁸² IRS Notice 2009-85 provides that a long-term resident ceases to be a lawful permanent resident if (1) the individual's lawful permanent resident status for U.S. immigration purposes has been revoked or has been administratively or judicially determined to have been abandoned, or if (2) the individual (a) commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, (b) does not waive the benefits of the treaty applicable to residents of the foreign country, and (c) notifies the IRS of such treatment on Forms 8833 and 8854.

¹⁷⁵I.R.C. § 877A(a).

¹⁷⁶Rev. Proc. 2015-53, § 3.30, 2015-44 I.R.B. 615.

¹⁷⁷I.R.C. § 877A(g)(1)(A).

¹⁷⁸I.R.C. § 877A(g)(1)(B).

¹⁷⁹I.R.C. § 7701(b)(6).

¹⁸⁰I.R.C. § 877A(g)(5); I.R.C. § 877(e)(2); I.R.C. § 7701(b)(6).

¹⁸¹Notice 97-19, 1997-1 C.B. 394 obsoleted in part on other grounds, Notice 2005-36, 2005-1 C.B. 1007.

¹⁸²Notice 2009-85, 2009-45 I.R.B. 598.

CHAPTER VII: U.S. FEDERAL INCOME TAXATION OF U.S. TRADE OR BUSINESS INCOME OF FOREIGN PERSONS

A. General Pattern of Taxation of U.S. Trade or Business Income of Foreign Persons. Nonresident aliens and foreign corporations are generally subject to U.S. federal income taxation on U.S.-source income (and certain limited types of foreign-source income) that is effectively connected with a U.S. trade or business.¹⁸³ The taxable income of a nonresident alien that is effectively connected with the conduct of a U.S. trade or business is generally taxed in the same manner and at the same rates as income of a U.S. citizen or resident alien.¹⁸⁴ Similarly, the taxable income of a foreign corporation that is effectively connected with a U.S. trade or business is generally taxed in the same manner and at the same rates as income of a U.S. corporation.¹⁸⁵

Nonresident aliens and foreign corporations are generally allowed deductions in computing effectively connected taxable income, but only if and to the extent that the deductions are related to income that is effectively connected.¹⁸⁶ The proper apportionment and allocation of such deductions are determined as provided in regulations prescribed by the Treasury.¹⁸⁷

B. Taxation of U.S. Capital Gain Income. A nonresident alien or foreign corporation's capital gain income that is effectively connected with the conduct of a U.S. trade or business is subject to U.S. federal income taxation in the same manner as the capital gain income of a U.S. resident or U.S. corporation, as the case may be. A nonresident alien or foreign corporation that earns capital gain income that is not effectively connected with the conduct of a U.S. trade or business is not subject to U.S. federal income taxation unless (1) such gain is described in I.R.C. § 871(a); (2) such gain results from the sale of a "U.S. real property interest;"¹⁸⁸ (3) the recipient is a nonresident alien individual who is present in the U.S. for 183 days or more during the taxable year;¹⁸⁹ or (4) the recipient is an individual who meets the definition of a resident alien for U.S. federal income tax purposes.¹⁹⁰

¹⁸³I.R.C. §§871(b), 882(a), 872(a), 882(b).

¹⁸⁴I.R.C. §§ 2(d), 872(a), 871(b), 873(a); *see also* Treas. Reg. §§ 1.1-1(a)(1) ("Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the U.S. and, to the extent provided by Section 871(b) . . . on the income of a nonresident alien individual.").

¹⁸⁵I.R.C. § 11(d), 882(b); *see also* Treas. Reg. § 1.11-1(a) ("[F]oreign corporations engaged in trade or business in the United States shall be taxable under section 11 only on their taxable income which is effectively connected with the conduct on a trade or business in the United States....").

¹⁸⁶I.R.C. §§ 873(a), 882(c).

¹⁸⁷I.R.C. § 882(c)(1)(A).

¹⁸⁸I.R.C. § 897.

¹⁸⁹I.R.C. § 871(a)(2); *but see* Joint Committee on Tax'n, "Description of the Chairman's Mark of the 'Jumpstart Our Business Strength (JOBS) Act,'" JCX-83-03 (Sept. 26, 2003) (propose to repeal Section 871(a)(2), which "can apply only in a very limited set of cases").

¹⁹⁰I.R.C. § 7701(b).

C. Branch Profits Tax Applies to Foreign Corporations Doing Business in the U.S. Foreign corporations doing business in the U.S. are subject to the branch profits tax.¹⁹¹ The branch profits tax is discussed in Part VII below.

D. Special Withholding Rules Applicable to Partnership Effectively Connected Income.

1. Withholding on Partnership Effectively Connected Taxable Income.

If a foreign or domestic partnership has effectively connected taxable income allocable under section 704 to a foreign partner, then the partnership must pay a withholding tax on the effectively connected taxable income that is allocable to its foreign partners.¹⁹² (For this purpose, a “foreign partner” generally means a nonresident alien individual, foreign corporation, foreign partnership, or foreign trust or estate.¹⁹³) The withholding tax amount payable by the partnership is generally equal to the partner’s effectively connected taxable income multiplied by the highest rate of tax in Section 11(b), in the case of a corporate partner, or Section 1, in the case of a non-corporate partner.¹⁹⁴

2. Determining Effectively-Connected Taxable Income. The term “effectively connected taxable income” generally means the excess of effectively-connected gross income of the partnership (including income treated as effectively connected) over allowable deductions that are connected to such income, with certain prescribed adjustments.¹⁹⁵

3. Service Issues Regulations Addressing Withholding Rules Applicable to Partnership Effectively Connected Income. On May 13, 2005, the Internal Revenue Service issued final regulations regarding the obligation of a partnership to pay a withholding tax on effectively connected taxable income allocable under Section 704 to a foreign partner.

E. Income Tax Treaties May Modify the General Rules of Taxation. U.S. income tax treaties often modify the general rules of taxation for nonresident aliens and foreign corporations doing business. For example, an applicable income tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment in the U.S. Tax treaties are discussed in Part XI below.

¹⁹¹I.R.C. § 884(a).

¹⁹²I.R.C. §§ 1446(a), 1446(b).

¹⁹³I.R.C. § 1446(e).

¹⁹⁴I.R.C. § 1446(b).

¹⁹⁵I.R.C. § 1446(c).

CHAPTER VIII: SELECTED U.S. REPORTING ISSUES.

A. U.S. Federal Income Tax Return.

1. Nonresident Alien. A nonresident alien individual must file a U.S. federal income tax return (Form 1040NR) in the U.S. if any of the following conditions are met: (1) the individual had U.S.-source income (even if the income was exempt from U.S. income tax under an applicable treaty exemption) unless the individual's full U.S. tax was withheld at source; or (2) the individual is engaged in the conduct of a U.S. trade or business whether or not he had income from that trade or business.¹⁹⁶ In Notice 2005-77,¹⁹⁷ the Internal Revenue Service announced that it will amend the regulations to eliminate the Form 1040NR filing requirement for a nonresident alien individual who earns less than the amount of one personal exemption as United States source wages that are effectively connected with a United States trade or business (effectively connected wages) and who is required to file a United States income tax return because of those wages. All nonresident alien individuals who earn effectively connected wages are entitled to at least one personal exemption under section 151. Therefore, by amending the regulations, the new exception would treat nonresident alien individuals who earn effectively connected wages in an amount that is less than the amount of one personal exemption more similarly to United States citizens and residents who earn wages of less than the exemption amount. The exception would apply even if the nonresident alien individual also has United States source fixed or determinable annual or periodical gains, profits, or income (FDAP), provided that his United States tax liability for such income is fully satisfied by the withholding of tax at source. The amendment to the regulations, however, will not affect the filing requirements of a nonresident alien individual who seeks a refund of an overpayment of United States tax, has a United States income tax liability with respect to FDAP that is not fully satisfied by withholding at source, or who has income exempt or partially exempt by reason of an income tax convention or any section of the Code.

Regulations incorporating the guidance set forth in Notice 2005-77 will apply to tax years beginning on or after January 1, 2006. Until such regulations are issued, nonresident alien individuals may rely on Notice 2005-77.

2. Foreign Corporation. A foreign corporation must file a U.S. federal income tax return (Form 1120F) in the U.S. if any of the following conditions are met: (1) the corporation had U.S.-source income (even if the income was exempt from U.S. income tax under an applicable treaty exemption) unless the corporation's full U.S. tax was withheld at source; or (2) the corporation is engaged in the conduct of a U.S. trade or business whether or not it had income from that trade or business.¹⁹⁸

3. Failure to Timely File Return Results in Loss of Deductions. Sections 874(a) and 882(c)(2) provide that nonresident aliens and foreign corporations, respectively, receive the benefit of deductions, however, "only by filing or causing to be filed with the Secretary a true and accurate return . . . including therein all the information which the Secretary

¹⁹⁶Treas. Reg. § 1.6012-1(b).

¹⁹⁷2005-46 I.R.B. 1.

¹⁹⁸Treas. Reg. § 1.6012-2(g).

may deem necessary for the calculation of such deductions”¹⁹⁹ If a true and accurate return is not filed, federal income tax is collected on the basis of gross income without any allocable deductions.²⁰⁰

“Sections 874(a) and 882(c)(2) are draconian provisions designed to induce foreign corporations and nonresident alien individuals to file tax returns.”²⁰¹ Although neither statute contains a time limit, the Treasury Regulations explicitly create a timely filing requirement.²⁰² Under the regulations, whether a return has been filed on a timely basis for purposes of Section 874(a) and 882(c)(2) is dependent upon whether the nonresident alien individual or foreign corporation has filed a return for the tax year immediately preceding the tax year for which deductions or credits are claimed.²⁰³ If a return was filed for the immediately preceding tax year, or if the current tax year is the first tax year for which a return is required to be filed, the required return for the current tax year must be filed within 16 months (18 months in the case of a foreign corporation) of the due date for filing the return for the current tax year.²⁰⁴ If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year for which a return is required to be filed) must have been filed no later than the earlier of the date which is 16 months (18 months in the case of a foreign corporation) after the due date for filing the return for the current taxable year or the date the IRS mails a notice to the taxpayer advising that the current year tax return has not been filed and that no deductions or credits may be claimed.²⁰⁵ These filing deadlines may be waived if the taxpayer establishes to the satisfaction of the Service that the taxpayer, based on the facts and circumstances, acted reasonably and in good faith in failing to file a federal income tax return.²⁰⁶

B. Internal Revenue Service - Section 6038A (Related Party Transactions - Form 5472). Certain foreign-owned U.S. corporations and domestic branches of foreign corporations that are engaged in a trade or business in the U.S. must file annually with the IRS a separate Form 5472, Information Return of a Foreign Owned Corporation, for each “related party” with which the reporting corporation had “reportable transactions” during its taxable year. In addition, the reporting corporation must maintain certain records relating to those transactions.²⁰⁷

¹⁹⁹I.R.C. §§ 874(a), 882(c)(2).

²⁰⁰Treas. Reg. §§ 1.874-1(a), 1.882-4(a)(2).

²⁰¹*Espinosa v. Commissioner*, 107 T.C. 146, 152 (1996).

²⁰²Treas. Reg. § 1.874-1(b)(1)(“[F]or purposes of computing the nonresident alien individual’s taxable income for any taxable year, otherwise allowable deductions and credits will be allowed only if a true and accurate return for that taxable year is filed by the nonresident alien individual on a timely basis.”); Treas. Reg. § 1.882-4(a)(3)(“[F]or purposes of computing the foreign corporation’s taxable income for any taxable year, otherwise allowable deductions . . . will be allowed only if a return for that taxable year is filed by the foreign corporation on a timely basis.”).

²⁰³Treas. Reg. § 1.874-1(b)(1); Treas. Reg. § 1.882-4(a)(3).

²⁰⁴Treas. Reg. § 1.874-1(b)(1); Treas. Reg. § 1.882-4(a)(3).

²⁰⁵Treas. Reg. § 1.874-1(b)(1); Treas. Reg. § 1.882-4(a)(3).

²⁰⁶See Treas. Reg. § 1.874-1(b)(2); Treas. Reg. § 1.882-4(a)(3)(ii).

²⁰⁷I.R.C. §§ 6038A, 6038C.

C. Agricultural Foreign Investment Disclosure Act of 1978. In response to some concern about the amount of foreign investment in U.S. property, including agricultural land, the Agricultural Foreign Investment Disclosure Act (“AFIDA”) was enacted on October 14, 1978.²⁰⁸ AFIDA provides that any foreign person who acquires or transfers any interest, other than a security interest, in agricultural land is required to submit a report to the Secretary of Agriculture not later than ninety (90) days after the date of such acquisition or transfer.²⁰⁹ Such foreign person should complete Form FSA-153, Agricultural Foreign Investment Disclosure Act Report.²¹⁰ Form FSA-153 is required to be filed with the County Farm Service Agency office in the county of location of the acquired agricultural land.²¹¹ A civil penalty not to exceed 25% of the fair market value of the agricultural land may be imposed for the failure to file the requisite report.²¹²

The term “foreign person” includes a United States corporation in which a significant interest or substantial control is directly or indirectly held by a foreign person.²¹³ Regulations that have been promulgated under AFIDA provide that the term “significant interest” or “substantial control” means a ten percent (10%) or more interest in a legal entity for the purpose of obligating such legal entity to report.²¹⁴

D. Bureau of Economic Analysis and Reporting Requirements. The Bureau of Economic Analysis (“BEA”) prepares official economic statistics, such as international transactions accounts. The BEA publishes two broad sets of statistics on outward direct investment and on inward direct investment: (1) statistics on international transactions and direct investment positions and (2) statistics on the activities of multinational enterprises.

1. Surveys of U.S. Direct Investment Abroad. All U.S. persons that own, directly or indirectly, 10 percent or more of the voting securities of an incorporated foreign business enterprise or an equivalent interest in an unincorporated foreign business enterprise are required to report. A U.S. person who is required to report is referred to as a “U.S. reporter.” An affiliate outside the U.S. in which a U.S. person holds a 10 percent or more voting interest (or the equivalent is referred to as a “foreign affiliate.” The surveys of U.S. direct investment abroad are as follows:

- a. Form BE-577;
- b. Form BE-11A;
- c. Form BE-11B;
- d. Form BE-11C;

²⁰⁸See 7 U.S.C. § 3501 (enacted under Pub. L. 95-460, § 2, 92 Stat. 1263 (Oct. 14, 1978); 7 C.F.R. § 781.1.

²⁰⁹7 U.S.C. § 3501a).

²¹⁰7 C.F.R. § 781.3(a); § 781.3(b).

²¹¹7 C.F.R. § 781.3(a).

²¹²7 U.S.C. § 3502.

²¹³7 U.S.C. § 3508(3)(C); 7 C.F.R. § 781.2(g).

²¹⁴See 7 C.F.R. § 781.2(k).

- e. Form BE-11D;
- f. Form BE-11 Claim for Exemption;
- g. Form BE-10A;
- h. Form BE-10B;
- i. Form BE-10C;
- j. Form BE-10D; and
- k. Form BE-10 Claim for Not Filing.

2. Surveys of Foreign Direct Investment in the U.S. Reporting is required of all U.S. business enterprises in which a foreign person owns, directly or indirectly, 10 percent or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest of an unincorporated U.S. business enterprise. A U.S. business enterprise that is required to report is referred to as a “U.S. affiliate.” A foreign person that owns a 10 percent or more voting interest in a U.S. affiliate is referred to as a “foreign parent.” The foreign parent is the first person outside the U.S. in a foreign chain of ownership. The surveys of foreign direct investment in the U.S. are as follows:

- a. Form BE-13A;
- b. Form BE-13B;
- c. Form BE-13C;
- d. Form BE-13D;
- e. Form BE-13E;
- f. Form BE-13 Claim for Exemption;
- g. Form BE-605;
- h. Form BE-605 Claim for Exemption;
- i. Form BE-15A;
- j. Form BE-15B;
- k. Form BE-15C;
- l. Form BE-15 Claim for Exemption;
- m. Form BE-12A;

- n. Form BE-12B;
- o. Form BE-12C; and
- p. Form BE-12 Claim for Not Filing.

E. International Transportation of Currency or Monetary Instruments. The Currency and Foreign Transactions Reporting Act of 1970 (“CFTRA”) was enacted in response to a growing concern about the unavailability of bank records of bank customers thought by U.S. law enforcement agencies to be engaged in criminal activities. CFTRA authorizes the Secretary of the Treasury to require reports on the international transportation and receipt of monetary instruments.²¹⁵ Pursuant to this authority, the Treasury issued regulations requiring that a form be filed reporting the international transportation and receipt of currency or monetary instruments that exceed \$10,000.²¹⁶ FinCen Form 105 is the form that should be used to report the international transportation of currency or monetary instruments. The failure to file Form 4790 can result in the imposition of civil and criminal sanctions.

FinCen Form 105 is required to be filed at the time of entry into the U.S. or at the time of departure, mailing or shipping from the U.S. of the currency or monetary instruments in question.²¹⁷ Such reports are filed with the customs officer in charge at any customs port of entry or departure. Where a person has received a monetary instrument or currency in an aggregate amount exceeding \$10,000 which has been transported, mailed or shipped to such person from outside of the U.S. with respect to which a report has not been filed, such person must file Form 105 within fifteen (15) days after receipt of the currency or monetary instrument.²¹⁸

The term “monetary instrument” means (1) coin or currency of the U.S. or any other country, (2) travelers checks in any form, (3) negotiable instruments (including checks, promissory notes and money orders) in bearer form, endorsed without restriction, made out to a fictitious payee, or otherwise in such form that title thereto passes upon delivery, (4) incomplete instruments (including checks, promissory notes and money orders) that are signed but on which the name of the payee has been omitted, and (5) securities or stock in bearer form or otherwise in such form that title thereto passes upon delivery. Monetary instruments do not include (1) checks or money orders made payable to the order of a named person which have not been endorsed or which bear restrictive endorsements, (2) warehouse receipts, or (3) bills of lading.²¹⁹

F. Foreign bank accounts.

²¹⁵See 31 U.S.C. §§ 5311, 5316.

²¹⁶31 C.F.R. § 1010.340.

²¹⁷31 C.F.R. § 1010.306(b)(1).

²¹⁸31 C.F.R. § 1010.306(b)(2).

²¹⁹See 31 C.F.R. § 1010.100(dd); General Instructions to Form 105.

1. Statutory and Regulatory Background. The Bank Secrecy Act²²⁰ authorizes the Secretary of the Treasury (Secretary), among other things, to issue regulations requiring persons to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, regulatory, and counter-terrorism matters.²²¹ The regulations implementing the BSA appear at 31 CFR Chapter X. The Secretary's authority to administer the BSA has been delegated to the Director of FinCEN.²²²

Under 31 U.S.C. § 5314(a), a U.S. citizen or resident, or person in, and doing business in, the United States is required to keep records and file reports, as specified by the Secretary of the Treasury, when that person enters into a transaction or maintains a relationship with a foreign financial agency.²²³ For this purpose, foreign financial agency generally means a person acting for a person as a financial institution, bailee, depository trustee, or agent, or acting in a similar way related to money, credit, securities, gold, or a transaction in money, credit, securities, or gold.²²⁴ Treasury is authorized to prescribe exemptions to the reporting requirement and to prescribe other matters the Secretary considers necessary to carry out section 5314.²²⁵

2. Question Regarding Foreign Bank Accounts in Part III of Schedule B of IRS Form 1040. Pursuant to 31 U.S.C. § 5314(a), Part III of Schedule B of IRS Form 1040 requires individuals to answer a question regarding foreign bank accounts.²²⁶ The exact wording of the question on the 2015 Form 1040, Schedule B, is: "At any time during 2015, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country." The instructions to the 2015 Schedule B provide the following additional directive:

Line 7a-Question 1. Check the "Yes" box if at any time during 2015 you had a financial interest in or signature authority over a financial account located in a foreign country. See the definitions that follow. Check the "Yes" box even if you are not required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

* * *

Line 7a-Question 2. See FinCEN Form 114 and its instructions to determine whether you must file the form. Check the "Yes" box if you are required to file the form; check the "No" box if you are not required to file the form.

If you checked the "Yes" box to Question 2 on line 7a, FinCEN Form 114 must be electronically filed with the Financial Crimes Enforcement Network (FinCEN)

²²⁰Titles I and II of Public Law 91-508, as amended, codified at 12 U.S.C. § 1829b, 12 U.S.C. § 1951-1959, and 31 U.S.C. §§ 5311-5314 and 5316-5332.

²²¹31 U.S.C. § 5311.

²²²31 C.F.R. § 583 (2011).

²²³31 U.S.C. § 5314(a).

²²⁴See 31 U.S.C. 5312(a)(1).

²²⁵See 31 U.S.C. 5314(b)(1).

²²⁶See I.R.M. § 4.26.16.2.1(1) (Rev. 07-01-2008); see generally I.R.M. § 5.21.6 – Report of Foreign Bank and Financial Accounts (Rev. 02-17-2009); Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities (JCX-65-08), July 23, 2008.

at the following website: <http://bsaefiling.fincen.treas.gov/main.html>. Do not attach FinCEN Form 114 to your tax return. To be considered timely, FinCEN Form 114 must be received by June 30, 2016.

Line 7b. If you are required to file FinCEN Form 114, enter the name of the foreign country or countries in the space provided on line 7b. Attach a separate statement if you need more space.

An individual who answers “yes” in response to the question asking whether the individual has an interest in or signature authority over a foreign account(s) exceeding \$10,000 must then file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (“FBAR”).²²⁷ This form must be received by June 30 of the year following the year when the \$10,000 threshold is met.²²⁸

3. Treasury Issues Final FBAR Regulations. On February 26, 2010, the Treasury Department published proposed FBAR regulations, as well as proposed revisions that clarify instructions for the FBAR.²²⁹ On February 24, 2011, FinCen issued final regulations regarding reports of foreign financial accounts.²³⁰ The final regulations (1) address the scope of the persons that are required to file reports of foreign financial accounts; (2) specifies the types of accounts that are reportable; and (3) provides filing relief in the form of exemptions for certain persons with signature or other authority over foreign financial accounts. The final regulations also adopt provisions intended to prevent persons subject to the rule from avoiding their reporting requirement. The final regulations are effective March 28, 2011, and apply to reports required to be filed by June 30, 2011, with respect to foreign financial accounts maintained in calendar year 2010, and for reports required to be filed with respect to all subsequent calendar years.²³¹

a. General Filing Requirements. Section 1010.350 generally requires each U.S. person having a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country to “report such relationship to the Commissioner of Internal Revenue for each year in which such relationship exists and . . . provide such information as shall be specified in a reporting form prescribed under 31 U.S.C. 5314 to be filed by such persons.”²³² Section 1010.306(c) requires the form to be filed with respect to foreign financial accounts exceeding \$10,000. The form must be filed on or before June 30 of each calendar year for accounts maintained during the previous calendar year.²³³

²²⁷31 C.F.R. § 1010.350(a); see Instructions to 2015 Form 1040, Schedule B; FinCEN BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²²⁸31 C.F.R. § 1010.306(c); see Form 114 (Effective Oct. 1, 2013).

²²⁹See Notice of Proposed Rulemaking, RIN 1506-AB08, [hereinafter “FBAR Preamble”], *reprinted at* 2010 TNT 39-25.

²³⁰Department of the Treasury, Financial Crimes Enforcement Network, 31 CFR Part 1010, RIN 1506-AB08, Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, *republished at* 2011 TNT 37-11.

²³¹*Id.*

²³²31 C.F.R. § 1010.350(a).

²³³31 C.F.R. § 1010.306(c).

Section 1010.420 requires records of accounts to be maintained for each person having a financial interest in or signature or other authority over such account.²³⁴ The records must be maintained for a period of five years.²³⁵ The form used to file the report required by section 1010.350(a) is FinCEN Form 114 -- Report of Foreign Bank and Financial Accounts (FBAR).²³⁶ The instructions to the FBAR specify which persons must file as well as the types of accounts that must be reported.

b. Statutory and Regulatory Elements.

(1) United States Person. “United States person” means (a) a citizen of the United States;²³⁷ (b) a resident of the United States; and (c) an entity, including but not limited to, a corporation, partnership, trust, or limited liability company created, organized, or formed under the laws of the United States, any State, the District of Columbia, the Territories and Insular Possessions of the United States, or the Indian Tribes.²³⁸ A resident of the United States is an individual who is a resident alien under I.R.C. § 7701(b) (modified to treat the United States as the States of the United States, the District of Columbia, the Indian lands (as that term is defined in the Indian Gaming Regulatory Act), and the Territories and Insular Possessions of the United States).²³⁹

(2) Bank, Securities or Other Financial Account in a Foreign Country. The BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014) provide that a foreign financial account is a financial account located outside of the United States.²⁴⁰ For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a

²³⁴31 C.F.R. § 1010.420.

²³⁵31 C.F.R. § 1010.420.

²³⁶31 C.F.R. § 1010.350(a).

²³⁷31 C.F.R. § 1010.350(b)(1).

²³⁸31 C.F.R. § 1010.350(b)(3); see also FIN-2011-G003 (Oct. 11, 2011), *reprinted at* 2012 TNT 3-18 (“As stated in the preamble to the final FBAR regulations, FinCEN does not expect officers or employees with signature or other authority to maintain records of the foreign financial accounts of their employers personally.¹ The same reasoning is applicable to former employees who had signature or other authority over, but no financial interest in, a foreign financial account with respect to his or her duties for a former employer during a reportable calendar year. Thus, FinCEN does not expect a former employee to maintain the records of the foreign financial accounts of their former employer personally. Additionally, due to proprietary and privacy concerns, FinCEN does not expect a former employer to provide information on foreign financial accounts to a former employee. Therefore, in such instances, a former employee must provide as much information as possible when filing an FBAR. At a minimum, the former employee must include the fact that the former employee had signature or other authority over a foreign financial account and must provide in Part IV, Items 34-42 information about his or her former employer for whom he or she was acting, including the name of the former employer, as well as his or her title with the former employer in Part IV, Item 43.”).

²³⁹31 C.F.R. § 1010.350(b)(2).

²⁴⁰The Regulations provides that a foreign country includes all geographical areas located outside of the United States. 31 C.F.R. § 1010.350(d). For this purpose, United States means the States of the United States, the District of Columbia, the Indian lands (as that term is defined in the Indian Gaming Regulatory Act), and the Territories and Insular Possessions of the United States.

foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.²⁴¹

(3) Types of Reportable Accounts.

(a) Bank Account. “Bank account” means a savings deposit, demand deposit, checking, or any other account maintained with a person engaged in the business of banking.²⁴²

(b) Securities Account. “Securities account” means an account with a person engaged in the business of buying, selling, holding or trading stock or other securities.²⁴³

(c) Other Financial Account. The term “other financial account” means:

i) An account with a person that is in the business of accepting deposits as a financial agency;²⁴⁴

ii) An account that is an insurance or annuity policy with a cash value;²⁴⁵

iii) An account with a person that acts as a broker or dealer for futures or options transactions in any commodity on or subject to the rules of a commodity exchange or association;²⁴⁶ or

iv) An account with a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions;²⁴⁷ or

v) An account with certain other investment funds.²⁴⁸

(4) Exceptions for certain accounts. The following accounts are not required to be reported:

²⁴¹BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²⁴²31 C.F.R. § 1010.350(c)(1).

²⁴³31 C.F.R. § 1010.350(c)(2).

²⁴⁴31 C.F.R. § 1010.350(c)(3)(i).

²⁴⁵31 C.F.R. § 1010.350(c)(3)(ii).

²⁴⁶31 C.F.R. § 1010.350(c)(3)(iii).

²⁴⁷31 C.F.R. § 1010.350(c)(3)(iv)(A).

²⁴⁸31 C.F.R. § 1010.350(c)(3)(iv)(B). Treasury has reserved guidance on this section of the regulations.

(a) Governmental Entities. An account of a department or agency of the United States, an Indian Tribe, or any State or any political subdivision of a State, or a wholly-owned entity, agency or instrumentality of any of the foregoing.²⁴⁹ For purposes of Form 114, this category includes a college or university that is an agency of, an instrumentality of, owned by, or operated by a governmental entity.²⁵⁰ It also includes an employee retirement or welfare benefit plan of a governmental entity.²⁵¹

(b) Certain Entities Exercising Governmental Authority. An account of an entity established under the laws of the United States, of an Indian Tribe, of any State, or of any political subdivision of any State, or under an intergovernmental compact between two or more States or Indian Tribes, that exercises governmental authority on behalf of the United States, an Indian Tribe, or any such State or political subdivision. For this purpose, an entity generally exercises governmental authority on behalf of the United States, an Indian Tribe, a State, or a political subdivision only if its authorities include one or more of the powers to tax, to exercise the power of eminent domain, or to exercise police powers with respect to matters within its jurisdiction.²⁵²

(c) International Financial Institution if the U.S. Government is a Member. An account of an international financial institution of which the United States government is a member.²⁵³

(d) U.S. Military Banking Facility. An account in an institution known as a “United States military banking facility” (or “United States military finance facility”) operated by a United States financial institution designated by the United States Government to serve United States government installations abroad even though the United States military banking facility is located in a foreign country.²⁵⁴

(e) Correspondent Accounts. Correspondent or nostro accounts that are maintained by banks and used solely for bank-to-bank settlements.²⁵⁵

(f) IRA Owners and Beneficiaries. An owner or beneficiary of an IRA is not required to report a foreign financial account held in the IRA.²⁵⁶

(g) Participants in and Beneficiaries of Tax-Qualified Retirement Plans. A participant in or beneficiary of a retirement plan described in

²⁴⁹31 C.F.R. § 1010.350(c)(4)(i).

²⁵⁰BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²⁵¹BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²⁵²31 C.F.R. § 1010.350(c)(4)(i).

²⁵³31 C.F.R. § 1010.350(c)(4)(ii).

²⁵⁴31 C.F.R. § 1010.350(c)(4)(iii).

²⁵⁵31 C.F.R. § 1010.350(c)(4)(iv).

²⁵⁶31 C.F.R. § 1010.350(g)(4).

Internal Revenue Code section 401(a), 403(a), or 403(b) is not required to report a foreign financial account held by or on behalf of the retirement plan.²⁵⁷

(h) Special Rule for Certain Accounts Jointly Owned by Spouses. The spouse of an individual who files an FBAR is not required to file a separate FBAR if the following conditions are met: (1) all the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse; (2) the filing spouse reports the jointly owned accounts on a timely filed FBAR electronically filed; and (3) the filers have completed and signed Form 114a, “Record of Authorization to Electronically File FBAR’s” (maintained with the filers’ records). Otherwise, both spouses are required to file separate FBARs, and each spouse must report the entire value of the jointly owned accounts.²⁵⁸

(i) Consolidated FBAR. If a United States person that is an entity is named in a consolidated FBAR filed by a greater than 50 percent owner, such entity is not required to file a separate FBAR.²⁵⁹

(5) Financial interest. A financial interest in a bank, securities or other financial account in a foreign country means an interest described below.

(a) Owner of record or holder of legal title. A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which he is the owner of record or has legal title whether the account is maintained for his own benefit or for the benefit of others. If an account is maintained in the name of more than one person, each United States person in whose name the account is maintained has a financial interest in that account.²⁶⁰

(b) Other financial interest. A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which the owner of record or holder of legal title is:

i) A person acting as an agent, nominee, attorney or in some other capacity on behalf of the United States person with respect to the account;²⁶¹

ii) A corporation in which the United States person owns directly or indirectly more than 50 percent of the voting power or the total value of the shares;²⁶²

²⁵⁷*Ibid.*

²⁵⁸BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²⁵⁹31 C.F.R. § 1010.350(g)(3); BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²⁶⁰31 C.F.R. § 1010.350(e)(1).

²⁶¹31 C.F.R. § 1010.350(e)(2)(i).

²⁶²31 C.F.R. § 1010.350(e)(2)(ii)

iii) A partnership in which the United States person owns directly or indirectly more than 50 percent of the interest in profits or capital;

iv) A trust, if the United States person is the trust grantor and has an ownership interest in the trust for United States federal tax purposes (as determined under Sections 671 through 679 of the Code);²⁶³

v) A trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income;²⁶⁴ or

vi) Any other entity in which the United States person owns directly or indirectly more than 50 percent of the voting power, total value of the equity interest or assets, or interest in profits;²⁶⁵

(6) Federal Tax Treatment Does Not Control Filing Requirement. The BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014) clarify that the federal tax treatment of an entity does not determine whether the entity has an FBAR filing requirement. For example, an entity that is disregarded for federal income tax purposes must file an FBAR, if otherwise required to do so. Similarly, a trust for which the trust income, deductions, or credits are taken into account by another person for federal income tax purposes must file an FBAR, if otherwise required to do so.²⁶⁶

(7) Signature or Other Authority. “Signature or other authority” generally means the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained.²⁶⁷ Individuals who have signature authority over, but no financial interest in, a foreign financial account are not required to report the account in the following situations:

(a) An officer or employee of a bank that is examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, or the National Credit Union Administration is not required to report signature authority over a foreign financial account owned or maintained by the bank.²⁶⁸

(b) An officer or employee of a financial institution that is registered with and examined by the Securities and Exchange Commission or Commodity

²⁶³31 C.F.R. § 1010.350(e)(2)(iii).

²⁶⁴31 C.F.R. § 1010.350(e)(2)(iv).

²⁶⁵31 C.F.R. § 1010.350(e)(2)(ii).

²⁶⁶BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

²⁶⁷31 C.F.R. § 1010.350(f)(1).

²⁶⁸31 C.F.R. § 1010.350(f)(2)(i).

Futures Trading Commission is not required to report signature authority over a foreign financial account owned or maintained by the financial institution.²⁶⁹

(c) An officer or employee of an Authorized Service Provider need not report that he has signature or other authority over a foreign financial account owned or maintained by an investment company that is registered with the Securities and Exchange Commission. “Authorized Service Provider” means an entity that is registered with and examined by the Securities and Exchange Commission and that provides services to an investment company registered under the Investment Company Act of 1940.²⁷⁰

(d) An officer or employee of an entity with a class of equity securities listed (or American depository receipts listed) on any United States national securities exchange need not report that he has signature or other authority over a foreign financial account of such entity. An officer or employee of a United States subsidiary of a United States entity with a class of equity securities listed on a United States national securities exchange need not file a report concerning signature or other authority over a foreign financial account of the subsidiary if the United States subsidiary is included in a consolidated report of the parent filed under this section.²⁷¹

(e) An officer or employee of an entity that has a class of equity securities registered (or American depository receipts in respect of equity securities registered) under section 12(g) of the Securities Exchange Act need not report that he has signature or other authority over the foreign financial accounts of such entity.²⁷²

(8) **Special Rule for Certain Trust Beneficiaries.** A special rule applies to a trust in which a United States person has a greater than 50 percent present beneficial interest in the assets or income of the trust for the calendar year. Such a beneficiary is not required to report the trust’s foreign financial accounts if the trust, trustee of the trust, or agent of the trust is a United States person that files a report disclosing the trust’s foreign financial accounts.²⁷³

(9) **Special Rule for U.S. Persons with a Financial Interest in, or Signature or Other Authority Over, 25 or More Foreign Financial Accounts.** A United States person having a financial interest in, or signature or other authority over, 25 or more foreign financial accounts need only provide the number of financial accounts and certain other basic information on the report, but will be required to provide detailed information concerning each account when so requested by Treasury.²⁷⁴

c. **Anti-Avoidance Rule.** The Regulations provide that a United States person that causes an entity, including but not limited to a corporation, partnership, or

²⁶⁹31 C.F.R. § 1010.350(f)(2)(ii).

²⁷⁰31 C.F.R. § 1010.350(f)(2)(iii).

²⁷¹31 C.F.R. § 1010.350(f)(2)(iv).

²⁷²31 C.F.R. § 1010.350(f)(2)(v).

²⁷³31 C.F.R. § 1010.350(g)(5).

²⁷⁴31 C.F.R. § 1010.350(g).

trust, to be created for a purpose of evading reporting has a financial interest in any bank, securities, or other financial account in a foreign country for which the entity is the owner of record or holder of legal title.²⁷⁵

G. Reporting Specified Foreign Financial Assets on Form 8938.

1. Enacting Legislation; Effective Date. Section 511 of the Hiring Incentives to Restore Employment Act,²⁷⁶ enacted on March 18, 2010 (the “**HIRE Act**”), amended the Internal Revenue Code by adding new section 6038D, Disclosure of Information With Respect to Foreign Financial Assets. Section 6038D applies to taxable years beginning after March 18, 2010.²⁷⁷

2. Requirement to Report Specified Foreign Financial Assets.

a. General Rule. Under new Section 6038D and the regulations thereunder, a specified person must attach Form 8938 to that person’s annual return if, during the tax year: (a) the person has an interest in one or more specified foreign financial assets; and (b) such assets have an aggregate fair market value exceeding either \$50,000 on the last day of the taxable year or \$75,000 at any time during the taxable year.²⁷⁸

b. No Form 8938 Filing Requirement if Specified Individual Is Not Required to File a Return. A specified person is not required to file Form 8938 for any taxable year for which the specified person is not required to file an annual return with the Internal Revenue Service,²⁷⁹ even if the value of the specified person’s specified foreign financial assets is more than the reporting threshold.²⁸⁰

3. Statutory and Regulatory Elements.

a. Specified Person. The term specified person means a specified individual or a specified domestic entity.²⁸¹

(1) Specified Individual.

(a) U.S. Citizens, Resident Aliens, and Certain Nonresident Aliens Electing to be Taxed as U.S. Residents. For section 6038D purposes, a specified individual is a U.S. citizen,²⁸² a resident alien of the United States under the green card

²⁷⁵31 C.F.R. § 1010.350(e)(3).

²⁷⁶Pub. L. No. 111-147, 124 Stat. 71.

²⁷⁷Hire Act, § 511(c).

²⁷⁸I.R.C. § 6038D(a); Treas. Reg. § 1.6038D-2(a)(1).

²⁷⁹Treas. Reg. § 1.6038D-2(a)(7)(i).

²⁸⁰Instructions to Form 8938 (2015).

²⁸¹Treas. Reg. § 1.6038D-1(a)(1).

²⁸²Treas. Reg. § 1.6038D-1(a)(2)(i).

test or the substantial presence test of I.R.C. § 7701(b),²⁸³ or certain nonresident aliens who have elected to be taxed as a U.S. resident.²⁸⁴

(b) Resident Aliens Electing to be Taxed as a Resident of a Foreign Country Under a Treaty Tie-Breaker Provision. If an individual qualifies as a resident alien under the green card test or the substantial presence test but elects to be taxed as a resident of a foreign country pursuant to a U.S. income tax treaty's residency tie-breaker rules, such individual is a specified individual for purposes of section 6038D and the regulations.²⁸⁵ The Instructions to Form 8938 (November 2015) provide that the Form 8938 should be attached to Form 1040NR.

(c) Certain Other Nonresident Aliens of the U.S. Who Are Resident in Puerto Rico or Certain U.S. Possessions. Certain nonresident aliens who are treated as residents under other sections of the Code are specified individuals for the purposes of section 6038D and the regulations. Thus, the rules under section 6038D apply to a nonresident alien who is a bona fide resident of Puerto Rico or certain U.S. possessions in the same manner as they apply to a U.S. citizen or resident.²⁸⁶

(2) Specified Domestic Entity. Section 6038D(f) provides that, to the extent provided by the Secretary in regulations or other guidance, Section 6038D shall apply to any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if the entity were an individual. On December 19, 2011, Treasury issued Proposed Regulation Section 1.6038-6 setting out the conditions under which a domestic entity will be considered a “specified domestic entity.”²⁸⁷ The Notice of Proposed Rulemaking issuing Proposed Regulation Section 1.6038D-6 states that “[u]ntil Prop. Reg. § 1.6038D-6 is issued as a final regulation, no domestic entity is required to file Form 8938 to report specified foreign financial assets with its annual return.”²⁸⁸ Similarly, the 2015 Instructions to Form 8938 state that “[u]ntil the IRS issues such [final] regulations, only individuals must file Form 8938.”

On February 23, 2016, the IRS issued final regulations providing guidance regarding the requirements for certain domestic entities to report specified foreign financial assets to the IRS.²⁸⁹ These regulations set for the conditions under which a domestic entity will be considered a specified domestic entity required to undertake such reporting. The regulations are effective on February 23, 2016.

²⁸³Treas. Reg. § 1.6038D-1(a)(2)(ii). For this purpose, resident alien status is determined pursuant to the rules of 7701(b) and Treas. Reg. §§ 301.7701(b)-1 through 301.7701(b)-9. Treas. Reg. § 1.6038D-T(a)(3); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

²⁸⁴Treas. Reg. § 1.6038D-1(a)(2)(iii); see I.R.C. § 6013(g) (election to treat nonresident alien as resident of the U.S.), 6013(h) (special joint return rule for year in which nonresident alien becomes resident of the U.S.).

²⁸⁵Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

²⁸⁶Treas. Reg. § 1.6038D-1(a)(2)(iv).

²⁸⁷Notice of Proposed Rulemaking, Fed. Reg. Vol. 76, No. 243, p. 78594 (Dec. 19, 2011).

²⁸⁸Preamble, 76 Fed. Reg. 78595 (Dec. 19, 2011).

²⁸⁹T.D. 9752.

b. Determining the Reporting Threshold.

(1) Unmarried Specified Individual Living in the U.S. An unmarried specified individual living in the U.S. satisfies the reporting threshold only if the total value of his or her specified foreign financial assets is more than \$50,000 on the last day of the tax year or more than \$75,000 on any day during the tax year.²⁹⁰

(2) Married Specified Individuals Living in the U.S. and Filing a Joint Return. Married specified individuals living in the U.S. and filing a joint return are not required to file Form 8938 unless the aggregate value of all of the specified foreign financial assets in which either spouse has an interest exceeds \$100,000 on the last day of the taxable year or \$150,000 at any time during the taxable year.²⁹¹

(3) Married Specified Individuals Living in the U.S. and Filing Separate Returns. If a married specified individual lives in the U.S. and files a separate return from his or her spouse, such individual is not required to file Form 8938 unless the aggregate value of such individual specified foreign financial assets exceeds \$50,000 on the last day of the taxable year or \$75,000 at any time during the taxable year.²⁹²

(4) Special Rule for Specified Individuals Living Abroad. The Preamble to the Temporary Regulations provides that an individual residing outside the United States can reasonably be expected to have a greater amount of specified foreign financial assets for reasons unrelated to the policies underlying section 6038D. The regulations therefore increase the reporting threshold of section 6038D(a) in the case of a specified individual whose tax home is in a foreign country and who meets either a foreign residency or foreign physical presence test (referred to as a “*qualified individual*”).²⁹³

(a) Specified Individual That Does Not File a Joint Return. A specified individual who is a qualified individual that does not file a joint return is not required to file Form 8938 unless the aggregate value of the specified foreign financial assets in which the specified individual has an interest exceeds \$200,000 on the last day of the taxable year or \$300,000 at any time during the taxable year.²⁹⁴

(b) Certain Married Specified Individuals Filing a Joint Return with One or Both Spouses Living Abroad. If married specified individuals file a joint annual return and either spouse is a qualified individual, the regulations provide that they are not required to file Form 8938 unless the aggregate value of all of the specified foreign

²⁹⁰ I.R.C. § 6038D(a); Temp Reg. § 1.6038D-2(a)(1); 2015 Instructions to Form 8938.

²⁹¹ Temp Reg. § 1.6038D-2(a)(2).

²⁹² 2015 Instructions to Form 8938.

²⁹³ See I.R.C. § 911(d)(1).

²⁹⁴ Treas. Reg. § 1.6038D-2(a)(3); 2015 Instructions to Form 8938.

financial assets in which either spouse has an interest exceeds \$400,000 on the last day of the taxable year or \$600,000 at any time during the taxable year.²⁹⁵

(5) Jointly-Owned Assets.

(a) Married Individual Filing a Joint Return.

Married specified individuals who file a joint annual return include the value of a specified foreign financial asset that they jointly own together only once in determining whether the aggregate value of all of the specified foreign financial assets in which either married specified individual has an interest exceeds the appropriate reporting threshold.²⁹⁶

(b) Married Individuals Filing Separately.

If a married specified individual files a separate annual return and his or her spouse is a specified individual, the married specified individual includes one-half of the value of a specified foreign financial asset that the married specified individual jointly owns with his or her spouse in determining whether the married specified individual has an interest in specified foreign financial assets the aggregate value of which exceeds the reporting threshold.²⁹⁷

(c) Joint Ownership With a Spouse Who is Not a Specified Individual or Someone Other Than a Spouse.

A joint interest in a specified foreign financial asset is subject to reporting under Section 6038D by each specified person that is a joint owner of the asset.²⁹⁸ In general, each joint owner who is a specified individual must include the full value of the jointly owned asset (and not the value of the specified person's interest) for purposes of determining whether the aggregate value of all specified foreign financial assets in which the joint owner has an interest exceeds the reporting thresholds.²⁹⁹ Thus, if a specified individual jointly owns an asset with a spouse who is not a specified individual or someone other than a spouse, such specified individual must include the full value of the jointly owned asset (and not just his or her interest) for purposes of determining whether the aggregate value of all specified foreign financial assets in which the joint owner has an interest exceeds the reporting thresholds.³⁰⁰

(6) Special Valuation Rule for Interest in a Foreign Trust.

For purposes of determining the aggregate value of specified foreign financial assets in which a specified person has an interest, if the specified person does not know or have reason to know based on readily accessible information the fair market value of the person's interest in a foreign trust during the taxable year, the value to be included in determining the aggregate value of the specified foreign financial assets is the maximum value (discussed below) of the specified person's interest in the foreign trust.³⁰¹

²⁹⁵Treas. Reg. § 1.6038D-2(a)(4); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

²⁹⁶Treas. Reg. § 1.6038D-2(c)(2).

²⁹⁷Treas. Reg. § 1.6038D-2(c)(3)(i).

²⁹⁸Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011); see Treas. Reg. § 1.6038D-2(c)(1)(i).

²⁹⁹Temp. Reg. § 1.6038D-2(c)(3)(ii).

³⁰⁰2015 Instructions to Form 8938.

³⁰¹Temp. Reg. § 1.6038D-5(f)(2)(ii).

(7) Special Valuation Rule for Interests in Foreign Estates, Pension Plans, and Deferred Compensation Plans. For purposes of determining the aggregate value of specified foreign financial assets in which a specified person has an interest, if the specified person does not know or have reason to know based on readily accessible information the fair market value of the person's interest in a foreign estate, foreign pension plan, or foreign deferred compensation plan during the taxable year, the value to be included in determining the aggregate value of the specified foreign financial assets is the fair market value, determined as of the last day of the taxable year, of the currency and other property distributed during the taxable year to the specified person as a beneficiary or participant.³⁰²

c. Specified Foreign Financial Assets. For purposes of section 6038D, specified foreign financial assets include financial accounts maintained by foreign financial institutions, as well as certain other foreign financial assets or instruments.³⁰³ An asset or instrument may be a specified foreign financial asset subject to reporting under section 6038D and the regulations even if the asset or instrument does not have a positive value.³⁰⁴

(1) Financial Accounts Maintained by a Foreign Financial Institution.

(a) General Rule. A specified foreign financial asset generally includes any financial account maintained by a foreign financial institution.³⁰⁵

i) Financial Account. Generally, for purposes of section 6038D, a financial account is (A) any depository or custodial account maintained by a foreign financial institution; and (B) any equity or debt interest in a foreign financial institution (other than interests which are regularly traded on an established securities market).³⁰⁶

ii) Foreign Financial Institution. A foreign financial institution is a financial institution that is a foreign entity.³⁰⁷ The 2015 Instructions to Form 8938 (Nov. 2011) state that “[a] foreign financial institution includes investment vehicles such as foreign mutual funds, foreign hedge funds, and foreign private equity funds.” For purposes of Section 6038D, a specified foreign financial asset includes a financial account maintained by a financial institution organized under the laws of a U.S. possession.³⁰⁸

(b) Treatment of Assets Held in a Foreign Financial Account. An asset held in a financial account maintained by a foreign financial institution is not required to be reported on Form 8938 separately from the reported financial account in which the

³⁰²Temp. Reg. § 1.6038D-5(f)(3)(ii).

³⁰³I.R.C. § 6038D(b); Temp. Reg. § 1.6038D-3(a); Temp. Reg. § 1.6038D-3(b).

³⁰⁴Temp. Reg. § 1.6038D-2(a)(5).

³⁰⁵Temp. Reg. § 1.6038D-3(a)(1).

³⁰⁶Treas. Reg. § 1.6038D-1(a)(7) (defining financial account by reference to Treas. Reg. § 1.1471-5(b)); see Treas. Reg. § 1.1471-5(b); 2015 Instructions to Form 8938.

³⁰⁷Treas. Reg. § 1.6038D-1(a)(9) (defining foreign financial institution by reference to Treas. Reg. § 1.1471-5(d)); see Treas. Reg. § 1.1471-5(d).

³⁰⁸Treas. Reg. § 1.6038D-3(a)(2).

asset is held.³⁰⁹ The value of an asset held in a financial account maintained by a foreign financial institution is included in determining the maximum value of that account.³¹⁰

(c) Excepted Financial Accounts. The following are not specified financial assets:

i) Accounts Maintained by U.S. Payors. A financial account maintained by a U.S. payor as defined in § 1.6049-5(c)(5)(i) (including assets held in such an account).³¹¹ For example, a specified person is not required to report a financial account maintained by a U.S. branch of a foreign financial institution described in § 1.1441-1(b)(2)(iv).³¹²

ii) Mark to Market Election. A financial account if the specified person uses mark-to-market accounting under section 475 for all of the holdings in the account.³¹³

(2) Other Specified Foreign Financial Assets. A specified foreign financial asset includes any asset that is held for investment outside of an account maintained by a financial institution and is: (a) stock or securities issued by a person other than a U.S. person;³¹⁴ (b) any interest in a foreign entity,³¹⁵ which is defined as any entity which is not a U.S. person;³¹⁶ and (c) a financial instrument or contract issued by a person other than a U.S. person or that has a counterparty that is a person other than a U.S. person.³¹⁷ The Preamble to the Temporary Regulations states that “[t]hese three categories are broad and overlap in certain cases such that an asset not held in a financial account may be within more than one of the statutory categories of section 6038D(b)(2).

(a) Examples of Other Specified Foreign Financial Assets. The regulations provide that examples of assets other than financial accounts that may be considered other specified foreign financial assets if they are held for investment include, but are not limited to:

- i)** Stock issued by a foreign corporation;³¹⁸
- ii)** A capital or profits interest in a foreign partnership;³¹⁹

³⁰⁹Treas. Reg. § 1.6038D-3(a)(1).

³¹⁰Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³¹¹Treas. Reg. § 1.6038D-3(a)(3)(i).

³¹²Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³¹³Treas. Reg. § 1.6038D-3(a)(3)(ii).

³¹⁴I.R.C. § 6038D(b)(2)(A); Treas. Reg. § 1.6038D-3(b)(1)(iii).

³¹⁵I.R.C. § 6038D(b)(2)(C); Treas. Reg. § 1.6038D-3(b)(1)(iii).

³¹⁶Treas. Reg. § 1.6038D-1(a)(10) (defining “foreign entity” by reference to Treas. Reg. § 1.1473-1(e)); see Treas. Reg. § 1.1473-1(e).

³¹⁷I.R.C. § 6038D(b)(2)(B); Temp. Reg. § 1.6038D-3(b)(1)(ii).

³¹⁸Treas. Reg. § 1.6038D-3(d)(1).

indebtedness issued by a foreign person;³²⁰

iii) A note, bond, debenture, or other form of

iv) An interest in a foreign trust;³²¹

v) An interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty;³²² and

vi) Any option or other derivative instrument with respect to any of the items listed as examples in this paragraph or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.³²³

(b) Held for Investment. An asset not held in an account maintained by a financial institution is held for investment for purposes of section 6038D and the regulations if the asset is not used or held for use in the specified person's trade or business.³²⁴ For this purpose, an asset is used in, or held for use in, the conduct of a trade or business and not held for investment if the asset is:

i) Held for the principal purpose of promoting the present conduct of a trade or business;³²⁵

ii) Acquired and held in the ordinary course of a trade or business, as, for example, in the case of an account or note receivable arising from that trade or business;³²⁶ or

iii) Otherwise held in a direct relationship to the trade or business.³²⁷ In determining whether an asset is held in a direct relationship to the conduct of a trade or business by a specified person, principal consideration will be given to whether the asset is needed in the trade or business of the specified person. An asset will be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset will be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of the trade or business. Conversely, an asset will be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future plant replacement, or future business

³¹⁹Treas. Reg. § 1.6038D-3(d)(2).

³²⁰Treas. Reg. § 1.6038D-3(d)(3).

³²¹Treas. Reg. § 1.6038D-3(d)(4).

³²²Treas. Reg. § 1.6038D-3(d)(5).

³²³Treas. Reg. § 1.6038D-3(d)(6).

³²⁴Treas. Reg. § 1.6038D-3(b)(3).

³²⁵Treas. Reg. § 1.6038D-3(b)(4)(i).

³²⁶Treas. Reg. § 1.6038D-3(b)(4)(ii).

³²⁷Treas. Reg. § 1.6038D-3(b)(4)(iii).

contingencies. Stock is never considered used or held for use in a trade or business for purposes of applying this test.³²⁸

An asset will be treated as held in a direct relationship to the conduct of a trade or business of a specified person if (a) the asset was acquired with funds generated by the trade or business of the specified person or the affiliated group of the specified person, if any; (b) the income from the asset is retained or reinvested in the trade or business; and (c) personnel who are actively involved in the conduct of the trade or business exercise significant management and control over the investment of such asset.³²⁹

(c) Assets Not Considered Specified Foreign Financial Assets. The following assets are not specified foreign financial assets --

i) An asset for which a specified person uses mark-to-market accounting under section 475;³³⁰ and

ii) An interest in a social security, social insurance, or other similar program of a foreign government.³³¹

d. Interest in a Specified Foreign Financial Asset.

(1) General Rule. For section 6038D purposes, a specified person is generally considered to have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected on the specified person's annual return (even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the asset for a particular taxable year).³³²

(2) Special Rule For Parents Making Election Under Code Section 1(g)(7). For purposes of section 6038D and the regulations, a parent that makes an election under section 1(g)(7) to include certain unearned income of a child in the parent's gross income required to be reported for the taxable year has an interest in any specified foreign financial asset held by the child.³³³

(3) Treatment of Specified Financial Assets Held by Entities.

(a) General Rule. A specified person is generally not treated as having an interest in any specified foreign financial assets held by a partnership, corporation, trust, or estate solely as a result of the specified person's status as a partner,

³²⁸Treas. Reg. § 1.6038D-3(b)(5)(i).

³²⁹Treas. Reg. § 1.6038D-3(b)(5)(ii).

³³⁰Treas. Reg. § 1.6038D-3(b)(2).

³³¹2015 Instructions to Form 8938.

³³²Treas. Reg. § 1.6038D-2(b)(1).

³³³Treas. Reg. § 1.6038D-2(b)(3).

shareholder, or beneficiary.³³⁴ This general rule is subject to certain exceptions for disregarded entities and grantor trusts as discussed below.

(b) Exception for Disregarded Entity. A specified person that is the owner of an entity disregarded as an entity separate from its owner (as provided in § 301.7701-2(c)(2)(i) of this chapter) (disregarded entity) is treated as having an interest in any specified foreign financial assets held by the disregarded entity.

(c) Exception for Specified Persons Treated as Owners of a Trust. A specified person that is treated as the owner of a trust or any portion of a trust under sections 671 through 679 is generally treated as having an interest in any specified foreign financial assets held by the trust or by the portion of the trust that the specified person owns.³³⁵ A specified person, however, that is treated as an owner of a domestic liquidating trust created pursuant to a court order issued in a bankruptcy under Chapter 7 or a confirmed plan under Chapter 11 of the Bankruptcy Code, a domestic widely held fixed investment trust, or any portion of such a trust under sections 671 through 679 is not required to file Form 8938 to report any specified foreign financial asset held by the trust.

(4) Special Rule for Foreign Estates and Foreign Trusts. A beneficial interest in a foreign trust or a foreign estate is not a specified foreign financial asset of a specified person unless the specified person knows or has reason to know based on readily accessible information of the interest. Receipt of a distribution from the foreign trust or foreign estate is deemed for this purpose to be actual knowledge of the interest.³³⁶

4. Reporting on Form 8938.

a. Required Information. A specified person required to report on Form 8938 must provide the following information with regard to each specified foreign financial asset:

(1) In the case of a financial account maintained by a foreign financial institution, the name and address of the foreign financial institution and the account number of the account;³³⁷

(2) In the case of stock or a security, the name and address of the issuer, and information that identifies the class or issue of which the stock or security is a part;³³⁸

(3) In the case of a financial instrument or contract, information that identifies the financial instrument or contract, including the names and addresses of all issuers and counterparties;³³⁹

³³⁴Treas. Reg. § 1.6038D-2(b)(4)(i).

³³⁵Treas. Reg. § 1.6038D-2(b)(4)(iii).

³³⁶Treas. Reg. § 1.6038D-3(c).

³³⁷I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(1).

³³⁸I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(2).

(4) In the case of an interest in a foreign entity, information that identifies the interest, including the name and address of the entity;³⁴⁰

(5) The maximum value of the specified foreign financial asset during the portion of the taxable year in which the specified person has an interest in the asset;³⁴¹

(6) In the case of a financial account that is a depository or custodial account, whether such financial account was opened or closed during the taxable year;³⁴²

(7) The date, if any, on which the specified foreign financial asset, other than a financial account that is a depository or custodial account, was either acquired or disposed of (or both) during the taxable year;³⁴³

(8) The amount of any income, gain, loss, deduction, or credit recognized for the taxable year with respect to the reported specified foreign financial asset, and the schedule, form, or return filed with the Internal Revenue Service on which the income, gain, loss, deduction, or credit, if any, is reported or included by the specified person;³⁴⁴

(9) The foreign currency exchange rate and, if the source of such rate is other than as described in § 1.6038D-5(c)(1), the source of the rate used to determine the specified foreign financial asset's U.S. dollar value, including maximum value;³⁴⁵ and

(10) For a specified foreign financial asset excepted from reporting on Form 8938 under § 1.6038D-7(a), the specified person must report the number of each type of form on which the asset is reported directly (for example, Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner," Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations," Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund," Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships," or Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.")³⁴⁶

b. Reporting Period.

(1) **Reporting Period for a Specified Individual.** The Form 8938 reporting period is the taxable year for a specified individual who is a U.S. citizen, a

³³⁹I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(3).

³⁴⁰I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(4).

³⁴¹I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(5).

³⁴²I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(6).

³⁴³I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(7).

³⁴⁴I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(8).

³⁴⁵I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(9).

³⁴⁶I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(10).

resident alien, or a bona fide resident of a U.S. possession for the entire taxable year.³⁴⁷ The reporting period for an individual who is a U.S. citizen or resident alien for less than the entire taxable year is the portion of the taxable year for which the specified individual is a U.S. citizen or resident alien.³⁴⁸

(2) Reporting Period for a Specified Domestic Entity. The Form 8938 reporting period for a specified domestic entity is the entity's taxable year.³⁴⁹

c. Treatment of Married Individuals.

(1) Married Specified Individuals Filing a Joint Return - Single Form 8938. Married specified individuals who file a joint annual return for the taxable year must fulfill their reporting requirements under Section 6038D by filing a single Form 8938.³⁵⁰ The single Form 8938 must report all of the specified foreign financial assets in which either married specified individual has an interest.³⁵¹ A specified foreign financial asset that is jointly owned by married specified individuals or a specified foreign financial asset held by a child for which the married specified individuals have made an election under section 1(g)(7) is reported only once on the single Form 8938.³⁵²

(2) Married Individuals Filing Separately. A married specified individual who files a separate annual return for the taxable year must fulfill the reporting requirements under section 6038D by filing a separate Form 8938 that reports all of the specified foreign financial assets in which the married specified individual has an interest, including assets jointly owned with the married specified individual's spouse or with another person.³⁵³

(3) Example. Assume two married specified individuals, H and W, jointly own a specified foreign financial asset with a value of \$90,000 at all times during the taxable year. H separately has an interest in a specified foreign financial asset with a value of \$10,000 at all times during the taxable year. W separately has an interest in a specified foreign financial asset with a value of \$1,000 at all times during the taxable year.³⁵⁴ The filing requirements are as follows:

(a) Married Specified Individuals Filing Separate Returns. If H and W file separate annual returns, the aggregate value of the specified foreign financial assets in which H has an interest at the end of the taxable year is \$55,000, comprising one-half of the value of the jointly owned asset, \$45,000, and the value of H's separately owned specified foreign financial asset, \$10,000. The aggregate value of the specified foreign financial

³⁴⁷Treas. Reg. § 1.6038D-2(a)(9); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁴⁸Treas. Reg. § 1.6038D-2(a)(9); 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁴⁹Treas. Reg. § 1.6038D-2(a)(9); 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁵⁰Treas. Reg. § 1.6038D-2(d)(1).

³⁵¹Treas. Reg. § 1.6038D-2(d)(1)(i).

³⁵²Treas. Reg. § 1.6038D-2(c)(2).

³⁵³Treas. Reg. § 1.6038D-2(d)(2).

³⁵⁴See Treas. Reg. § 1.6038D-2(f).

assets in which W has an interest at the end of the taxable year is \$46,000, comprising one-half of the value of the jointly owned asset, \$45,000, and the value of W's separately owned specified foreign financial asset, \$1,000. H must file Form 8938 with his annual return for the taxable year because the aggregate value of the specified foreign financial assets in which H has an interest exceeds the applicable reporting threshold (\$50,000). H must report the maximum value of the entire jointly owned asset, \$90,000, and the maximum value of the separately owned asset, \$10,000. The aggregate value of the specified foreign financial assets in which W has an interest, \$46,000, does not exceed the applicable reporting threshold. W is not required to file Form 8938 with her separate annual return.³⁵⁵

(b) Married Specified Individuals Filing a Joint Return. If H and W file a joint annual return, they must file a single Form 8938 with their joint annual return for the taxable year because the aggregate value of all of the specified foreign financial assets in which either H and W have an interest (\$90,000 (included only once), \$10,000, and \$1000, or \$101,000) exceeds the applicable reporting threshold (\$100,000). The single Form 8938 must report the maximum value of the jointly owned specified foreign financial asset, \$90,000, and the maximum value of the specified foreign financial assets separately owned by H and W, \$10,000 and \$1,000, respectively.³⁵⁶

d. Treatment of Certain Assets Excepted from Reporting on Form 8938.

(1) Treatment of Certain Assets Reported on Other Forms. As discussed below, certain specified foreign financial assets are excepted from the reporting obligations imposed under section 6038D. A specified person required to file Form 8938 with the Internal Revenue Service is not required to report a specified foreign financial asset on Form 8938 if the asset is reported or reflected on a Form 3520 (in the case of a specified person who is the beneficiary of a foreign trust), Form 5471, Form 8621, Form 8865, or Form 8891 (limited to certain tax years) timely filed with the Internal Revenue Service by the specified person for the taxable year,³⁵⁷ and the Form 8938 indicates the filing of the form on which the asset is reported.³⁵⁸ In addition, the value of specified foreign financial assets that qualify for this exception is included for purposes of determining whether the aggregate value of specified foreign financial assets in which a specified individual has an interest exceeds the applicable reporting threshold.³⁵⁹

(2) Treatment of Certain Grantor Trusts.

(a) Foreign Grantor Trusts. A specified person required to file Form 8938 that is treated as an owner of a foreign trust or any portion of such a trust under sections 671 through 679 is not required to report any specified foreign financial asset held by the trust on Form 8938 provided (1) the specified person reports the trust on a Form 3520

³⁵⁵Treas. Reg. § 1.6038D-2(d).

³⁵⁶Treas. Reg. § 1.6038D-2(d).

³⁵⁷See Treas. Reg. § 1.6038D-7(a)(1)(i).

³⁵⁸See Treas. Reg. § 1.6038D-7(a)(1)(ii); see Form 8938, Part IV.

³⁵⁹Treas. Reg. § 1.6038D-2(a)(6).

timely filed with the Internal Revenue Service for the taxable year, (2) the trust timely files Form 3520-A with the Internal Revenue Service for the taxable year, and (3) the Form 8938 filed by the specified person for the taxable year indicates the filing of the Form 3520 and the Form 3520-A.³⁶⁰

(b) Widely Held Fixed Investment Trusts and Certain Liquidating Trusts. Another category of assets excepted from reporting are assets considered owned by a specified person that is treated as the owner of certain widely-held fixed investment trusts and certain liquidating trusts.³⁶¹ Additionally, certain assets held by a specified individual who is a bona fide resident of a U.S. possession are also excepted from reporting.³⁶² Specified foreign financial assets that qualify for either of these two exceptions are not included for purposes of determining whether the aggregate value of specified foreign financial assets in which a specified person has an interest exceeds the applicable reporting threshold.³⁶³

5. Valuation of Assets.

a. Fair Market Value Standard. The value of a specified foreign financial asset must be determined both for purposes of determining if the aggregate value of the specified foreign financial assets in which a specified person holds an interest exceeds the reporting thresholds and for purposes of reporting the maximum value of a specified foreign financial asset on Form 8938.³⁶⁴ The value of a specified foreign financial asset for both of these purposes generally is the asset's fair market value.³⁶⁵

(1) Maximum Value. The maximum value of a specified foreign financial asset means a reasonable estimate of the asset's highest fair market value during the taxable year.³⁶⁶

(2) U.S. Dollars. For purpose of determining the aggregate value of specified foreign financial assets in which a specified person has an interest and determining the maximum value of a specified foreign financial asset, the value of a specified foreign financial asset denominated in a foreign currency during the taxable year must be determined in the foreign currency and then converted to U.S. dollars.³⁶⁷

(3) Assets With No Positive Value. If the maximum value of a specified foreign financial asset is less than zero, the value of the specified foreign financial asset is treated as zero for the purposes of determining the aggregate value of specified foreign

³⁶⁰Treas. Reg. § 1.6038D-7(a)(2).

³⁶¹See Treas. Reg. § 1.6038D-7(b).

³⁶²See Treas. Reg. § 1.6038D-7(c).

³⁶³Treas. Reg. § 1.6038D-2(a)(6).

³⁶⁴Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁶⁵Treas. Reg. 1.6038D-5(a).

³⁶⁶Treas. Reg. § 1.6038D-5(b)(1).

³⁶⁷Treas. Reg. § 1.6038D-5(b)(2).

financial assets in which a specified person has an interest and determining the maximum value of a specified foreign financial asset required to be reported on Form 8938.³⁶⁸

(4) Foreign Currency Conversion. If a specified foreign financial asset is denominated in a foreign currency, the value of the asset for purposes of determining both the aggregate value of specified foreign financial assets in which a specified person holds an interest and the maximum value of the specified foreign financial asset is first determined in the foreign currency prior to conversion into U.S. dollars (that is, independently of exchange rate fluctuations during the year).³⁶⁹ The asset's foreign currency value is then converted into U.S. dollars at the year-end rate for converting the foreign currency into U.S. dollars (that is, the rate to purchase U.S. dollars).³⁷⁰ The U.S. Treasury Department's Bureau of the Fiscal Service foreign currency exchange rate is to be used to convert the value of a specified foreign financial asset into U.S. dollars.³⁷¹ If no U.S. Treasury Department Bureau of the Fiscal Service foreign currency exchange rate is available, another publicly available foreign currency exchange rate may be used to determine an asset's maximum value, but the use of such rate must be disclosed on Form 8938.³⁷²

b. Valuing Financial Accounts. The maximum value of a financial account means a reasonable estimate of the maximum value of the holdings of the financial account at any time during the taxable year.³⁷³ A specified person may rely upon periodic account statements provided at least annually for reporting a financial account's maximum value absent actual knowledge or reason to know based on readily accessible information that the statements do not reflect a reasonable estimate of the maximum account value during the taxable year.³⁷⁴ The value of an asset held in a financial account maintained by a foreign financial institution is included in determining the value of that financial account.³⁷⁵

c. Valuing Other Specified Foreign Financial Assets.

(1) General Rule. For purposes of determining the maximum value of a specified foreign financial asset other than a financial account maintained with a foreign financial institution, a specified person may generally treat the asset's fair market value on the last day during the taxable year on which the specified person has an interest in the asset as the maximum value of the asset.³⁷⁶ The specified person may not use this valuation approach if the specified person has actual knowledge or reason to know based on readily accessible information that the fair market value determined as of such date does not reflect a reasonable estimate of the maximum value of the asset during the year (for example, because there is a

³⁶⁸Treas. Reg. § 1.6038D-5(b)(3).

³⁶⁹Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011); *see* Treas. Reg. § 1.6038D-5(b)(2).

³⁷⁰Treas. Reg. § 1.6038D-5(c)(3); Treas. Reg. § 1.6038D-5(c)(4).

³⁷¹Treas. Reg. § 1.6038D-5T(c)(1).

³⁷²Treas. Reg. § 1.6038D-5(c)(2).

³⁷³Treas. Reg. § 1.6038D-5(b)(1); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁷⁴Treas. Reg. § 1.6038D-5(d).

³⁷⁵Treas. Reg. § 1.6038D-5(e).

³⁷⁶Treas. Reg. § 1.6038D-5(f)(1).

reason to know that the asset's value declined significantly during the year).³⁷⁷ The Preamble provides that a specified person may determine the fair market value of a specified foreign financial asset based on information publicly available from reliable financial information sources or from other verifiable sources.³⁷⁸ The Preamble also states that, even if there is no information from reliable financial information sources regarding the fair market value of a reported asset, the regulations do not require a specified person to obtain an appraisal by a third party in order to reasonably estimate the asset's fair market value.³⁷⁹

(2) Special Valuation Rules for Interests in Foreign Trusts.

If a specified person is a beneficiary of a foreign trust, the maximum value of the specified person's interest in the trust is the sum of:

(a) The fair market value, determined as of the last day of the taxable year, of all of the currency or other property distributed from the foreign trust during the taxable year to the specified person as a beneficiary; and

(b) The value as of the last day of the taxable year of the specified person's right as a beneficiary to receive mandatory distributions from the foreign trust as determined under section 7520.³⁸⁰

d. Special Valuation Rule for Interests in Foreign Estates, Pension Plans, and Deferred Compensation Plans. The maximum value of a specified person's interest in a foreign estate, foreign pension plan, or a foreign deferred compensation plan is the fair market value, determined as of the last day of the taxable year, of the specified person's beneficial interest in the assets of the foreign estate, foreign pension plan, or foreign deferred compensation plan.³⁸¹ If the specified person does not know or have reason to know based on readily accessible information such fair market value, the maximum value to be reported is the fair market value, determined as of the last day of the taxable year, of the currency and other property distributed during the taxable year to the specified person as a beneficiary or participant.³⁸²

e. Special Rules for Jointly owned Interests. The Instructions to Form 8938 (2015) contain special rules for jointly-owned interests.

6. Penalties for Failure to Disclose.

a. General Rule. If a specified person fails to file a Form 8938 that includes the required information with respect to any taxable year at the time and in the manner described in section 6038D and the regulations thereunder, a penalty of \$10,000 will apply to

³⁷⁷Treas. Reg. § 1.6038D-5(f)(1); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁷⁸Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁷⁹Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

³⁸⁰Treas. Reg. § 1.6038D-5(f)(2)(i).

³⁸¹Treas. Reg. § 1.6038D-5(f)(3)(i).

³⁸²Treas. Reg. § 1.6038D-5(f)(3)(i).

that specified person.³⁸³ If any such failure continues for more than 90 days after the day on which the Commissioner or his delegate mails a notice of the failure to the specified person required to file the Form 8938, the specified person is subject to an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which the failure continues after the 90-day period has expired.³⁸⁴ The additional (or continuation) penalty is limited to a maximum of \$50,000 for each such failure.³⁸⁵

b. Married Individuals Filing a Joint Annual Return. Married specified individuals who file a joint annual return and fail to file a required Form 8938 that includes the required information with respect to any taxable year at the time and in the manner described in section 6038D and the regulations thereunder are subject to penalties under as if the married specified individuals are a single specified person.³⁸⁶ The liability of married specified individuals who file a joint annual return with respect to penalties under this section is joint and several.³⁸⁷

c. Presumption of Aggregate Value. For the purpose of assessing the penalties for failure to disclose, if the Revenue Service determines that a specified person has an interest in one or more specified foreign financial assets, and the specified person has not provided sufficient information to demonstrate the aggregate value of the assets upon request by the Secretary, then the aggregate value of the assets is treated as being in excess of the applicable reporting threshold.³⁸⁸

d. Reasonable Cause Exception. If a specified person shows that the failure to report the required information is due to reasonable cause and not due to willful neglect, no penalty will be imposed.³⁸⁹ To show that the failure to report is due to reasonable cause and not due to willful neglect, the specified person must make an affirmative showing of all the facts alleged as reasonable cause for the failure to report.³⁹⁰ The determination of whether a failure to disclose a specified foreign financial asset on Form 8938 was due to reasonable cause and not due to willful neglect is made on a case-by-case basis, taking into account all pertinent facts and circumstances. For this purpose, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the specified person (or any other person) for disclosing the required information is not reasonable cause.³⁹¹

7. Coordination with Form 114. The Instructions to Form 8938 (2015) provide that “[f]iling Form 8938 does not relieve you of the requirement to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), if you are otherwise required to file the FBAR.”

³⁸³I.R.C. § 6038D(d)(1); Treas. Reg. § 1.6038D-8(a).

³⁸⁴I.R.C. § 6038D(d)(2); Treas. Reg. § 1.6038D-8(c).

³⁸⁵I.R.C. § 6038D(e); Treas. Reg. § 1.6038D-8(c).

³⁸⁶Treas. Reg. § 1.6038D-8(b).

³⁸⁷Treas. Reg. § 1.6038D-8(b).

³⁸⁸I.R.C. § 6038D(e); Treas. Reg. § 1.6038D-8(d).

³⁸⁹I.R.C. § 6038D(g); Treas. Reg. § 1.6038D-8(e)(1).

³⁹⁰Treas. Reg. § 1.6038D-8(e)(2).

³⁹¹I.R.C. § 6038D(g); Treas. Reg. § 1.6038D-8(e)(3).

H. IRS Publishes Proposed Regulations on Country-by Country Reporting. On December 21, 2015, the IRS published annual country-by-country reporting rules applicable to U.S. persons that are the ultimate parent entity of a multinational enterprise (“MNE”) group with annual revenue for the preceding accounting period of \$850 million or more.³⁹² The regulations require such a parent entity to file an annual report containing information on a country-by-country basis related to the MNE group’s income and taxes paid, together with certain indicators of the location of economic activity within the MNE group.³⁹³

³⁹²Prop. Treas. Reg. § 1.6038-4(a); Prop. Treas. Reg. § 1.6038-4(h).

³⁹³Prop. Reg. § 1.6038-4(d).

CHAPTER IX: THE BRANCH PROFITS TAX

A. Application and Tax Rate. In addition to the regular corporate income tax imposed on foreign corporations doing business in the U.S., the U.S. imposes a flat 30-percent branch profits tax (or such lesser rate as is imposed by an applicable income tax treaty) on the “dividend equivalent amount” of a foreign corporation doing business in the U.S.³⁹⁴ The “dividend equivalent amount” generally is the U.S. branch’s earnings and profits effectively connected with a U.S. trade or business³⁹⁵ **with** certain adjustments.

1. Items of Income Excluded from Branch Tax Computation of Effectively-Connected Earnings and Profits. The following earnings and profits attributable to income effectively connected with a U.S. trade or business are excluded from the imposition of branch profits tax:

- a. Certain foreign transportation earnings;³⁹⁶
- b. Earnings derived from the sale of any interest in U.S. real property holding corporations;³⁹⁷
- c. Earnings derived by certain corporations organized in a U.S. possession;³⁹⁸ and
- d. Earnings derived by certain captive insurance companies.³⁹⁹

2. Adjustments to Reflect Changes in U.S. Net Equity. In arriving at the dividend equivalent amount, a branch’s effectively connected earnings and profits are adjusted to reflect changes in a branch’s U.S. net equity (i.e., the excess of the branch’s assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).⁴⁰⁰ The first adjustment reduces the dividend equivalent amount to the extent the branch’s earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities).⁴⁰¹ The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.⁴⁰²

B. Branch-Level Interest Tax. Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a U.S. corporation and therefore is subject to U.S.

³⁹⁴I.R.C. § 884(a); Treas. Reg. § 1.884-1(a).

³⁹⁵I.R.C. § 884(b); Treas. Reg. § 1.884-1(b)(1).

³⁹⁶I.R.C. § 884(d)(2)(A); Treas. Reg. § 1.884-1(f)(2)(i).

³⁹⁷I.R.C. § 884(d)(2)(C); Treas. Reg. § 1.884-1(f)(2)(iii).

³⁹⁸I.R.C. § 884(d)(2)(E); Treas. Reg. § 1.884-1(f)(2)(vi).

³⁹⁹I.R.C. § 884(d)(2)(D); Treas. Reg. § 1.884-1(f)(2)(iv).

⁴⁰⁰I.R.C. § 884(b); Treas. Reg. § 1.884-1(b)(2).

⁴⁰¹I.R.C. §§ 884(b)(1), 884(c); Treas. Reg. § 1.884-1(b)(2).

⁴⁰²I.R.C. §§ 884(b)(2), 884(c); Treas. Reg. § 1.884-1(b)(3).

withholding tax (if the interest is paid to a foreign person).⁴⁰³ Certain “excess interest” of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and therefore is subject to U.S. 30-percent withholding tax.⁴⁰⁴ For this purpose, excess interest is the excess of the interest deduction allocated or apportioned with respect to the U.S. trade or business over the amount of interest paid by such trade or business.⁴⁰⁵

C. Anti-Treaty Shopping Provision Under Branch Profits Tax. Special anti-treaty shopping rules apply for purposes of the branch profits tax. In order to take advantage of a treaty provision reducing or eliminating the branch profits tax, the foreign corporation must be a “qualified resident” of the treaty country.⁴⁰⁶ A “qualified resident” means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless:

1. 50-percent or more (by value) of the stock of such foreign corporation is owned by individuals who are not residents of such foreign country and who are not U.S. citizens or resident aliens;⁴⁰⁷ or

2. 50-percent or more of the foreign corporation’s income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or U.S. citizens or resident aliens.⁴⁰⁸

Certain additional rules apply to dividends paid by foreign corporations that qualify for a reduced branch profits tax rate under an income tax treaty.⁴⁰⁹

D. Exception for Termination of U.S. Branch. A foreign corporation will not be subject to the branch profits tax in the year in which a foreign corporation completely terminates all of its U.S. trade or business.⁴¹⁰ A foreign corporation’s previously taxed accumulated effectively connected earnings and profits are extinguished as a result of a complete termination of all of the U.S. trade or business of a foreign corporation.⁴¹¹

⁴⁰³I.R.C. § 884(f)(1)(A); Treas. Reg. § 1.884-4(a)(1).

⁴⁰⁴I.R.C. § 884(f)(1)(B); Treas. Reg. § 1.884-4(a)(2).

⁴⁰⁵I.R.C. §§ 884(f)(1)(B), 884(f)(2); Treas. Reg. § 1.884-4(a)(2)(i).

⁴⁰⁶I.R.C. § 884(e)(1); Treas. Reg. § 1.884-5.

⁴⁰⁷I.R.C. § 884(e)(4)(A)(i); Treas. Reg. § 1.884-5.

⁴⁰⁸I.R.C. § 884(e)(4)(A)(ii); Treas. Reg. § 1.884-5.

⁴⁰⁹See I.R.C. § 884(e)(3)(B).

⁴¹⁰Temp. Reg. § 1.884-2T(a).

⁴¹¹See also Announcement 94-42, 1994-12 I.R.B. 8 (“A foreign corporation will use Form 8848 if it has completely terminated all of its U.S. trade or business during the tax year . . .”).

CHAPTER X: U.S. INCOME TAXATION OF U.S. SOURCE FIXED DETERMINABLE ANNUAL OR PERIODICAL INCOME

A. General Patterns of Taxation of Fixed Determinable, Annual or Periodical Income.

1. Effectively Connected Fixed Determinable, Annual or Periodical Income. If effectively connected with a U.S. trade or business, U.S. source fixed determinable, annual or periodical (“FDAP”) income (for example, interest, dividends, rents, royalties) earned by a nonresident alien or foreign corporation is subject to tax, with appropriate deductions, at ordinary rates.⁴¹² Generally, no withholding is required for any income that is effectively connected with the conduct of a U.S. trade or business (other than compensation for personal services).⁴¹³ In order to avoid withholding, persons conducting U.S. trades or businesses are required to file certain prescribed forms with withholding agents for each tax year for which such persons will be entitled to the income, and before payment of the income in respect of which it applies.

2. Non-Effectively Connected FDAP Income. Nonresident aliens and foreign corporations are subject to a 30% tax (or such lesser rate as is determined by an applicable income tax treaty) on most items of U.S. source FDAP income that are not effectively connected with the conduct of a trade or business in the U.S.⁴¹⁴ FDAP income includes:

“interest (other than original issue discount as defined in Section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income . . . *but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.*”⁴¹⁵

The 30% tax liability is generally collected by way of withholding at source.⁴¹⁶

B. Special Issues Relating to Non-Effectively Connected FDAP Income.

1. Treatment of Original Issue Discount. As a general rule, nonresident aliens and foreign corporations are subject to a 30% tax on U.S.-source interest that is not effectively connected with the conduct of a U.S. trade or business.⁴¹⁷ Original issue discount is

⁴¹²I.R.C. §§ 871(a), 871(b), 881(a), 882(a)(1).

⁴¹³I.R.C. § 1441(c)(1).

⁴¹⁴I.R.C. §§ 871(a) and 881(a); *see also Central de Gas de Chihuahua v. Commissioner*, 102 T.C. 515, 517 (1994) (no actual payment required under I.R.C. § 882 and allocation of rent under I.R.C. § 482 provides a sufficient basis for imposing the 30% tax).

⁴¹⁵I.R.C. §§ 871(a)(1)(A) and 881(a)(1).

⁴¹⁶I.R.C. § 1441(a) (withholding rules for payments to non-resident alien individuals and foreign partnerships); I.R.C. § 1442(a) (withholding rules for payments to foreign corporations).

⁴¹⁷I.R.C. §§ 871(a)(1)(A), 881(a)(1).

excluded from this general rule.⁴¹⁸ “Original issue discount” (or “OID”) is generally defined as the excess (if any) of the stated redemption price at maturity of an obligation, over the issue price of the obligation.⁴¹⁹

Although original issue discount is excluded from the 30% tax on U.S.-source interest, special rules apply with respect to certain amounts received with respect to original issue discount obligations, but only to the extent the amounts received are not effectively connected with the conduct of a U.S. trade or business.⁴²⁰ An “original issue discount obligation” is generally any evidence of indebtedness having OID.⁴²¹

a. Treatment of Domestic Holders of OID Instruments. As a general rule, domestic holders of OID instruments are required to include in income an amount equal to the sum of the daily portions of the OID for each day during the tax year in which such holder held such instrument, and the inclusion increases basis.⁴²² Congress did not intend this increase in basis to apply to untaxed foreign investors, however.⁴²³ The basis of the OID instrument for the purpose of computing gain does not increase during the period the foreign investor holds it unless the U.S. taxed the investor on the OID.

b. Payments on Original Issue Discount Obligation. In the case of a payment on an “original issue discount obligation,” nonresident aliens and foreign corporations are subject to a 30% tax on the amount of original issue discount accruing while such obligation was held by the nonresident alien individual or foreign corporation.⁴²⁴ The 30% tax, however, applies only to the extent that:

(1) The tax does not exceed the amount of the payment on the original issue discount obligation (less withholding tax imposed on the payment);⁴²⁵ and

(2) The discount has not previously been taken into account under this provision.⁴²⁶

c. Payments Received from Sale or Exchange of Original Issue Discount Obligations. In the case of the sale or exchange of an “original issue discount obligation,” nonresident aliens and foreign corporations are subject to a 30% tax on the amount of the original issue discount accruing while such obligation was held by the nonresident alien or foreign corporation.⁴²⁷ The 30% tax, however, applies only to the original issue discount that

⁴¹⁸I.R.C. §§ 871(a)(1)(A), 881(a)(1).

⁴¹⁹I.R.C. § 1273(a)(1).

⁴²⁰I.R.C. §§ 871(a)(1)(C), 881(a)(3).

⁴²¹I.R.C. §§ 871(g)(1)(A), 881(e).

⁴²²I.R.C. §§ 1272(a)(1), 1272(d)(2).

⁴²³Staff of the Joint Comm. On Taxation, 98th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1984*, 402 403 (1984).

⁴²⁴I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

⁴²⁵I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

⁴²⁶I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

⁴²⁷I.R.C. §§ 871(a)(1)(C)(i), 881(a)(3)(A).

accrued while the obligation was held by the nonresident alien or foreign corporation and only to the extent such discount was not taken into account in prior payments.⁴²⁸

d. Exclusions from Definition of “Original Issue Discount Obligation.” There are two special exclusions from the definition of the term “original issue discount obligation”:

(1) Short-Term Obligations. The term does not include any obligation payable 183 days or less from the date of original issue.⁴²⁹

(2) Tax-Exempt Obligations. The term does not include any obligation that produces certain tax-exempt income.⁴³⁰

2. Special Treatment of Interest on Deposits. Interest on deposits with banks and savings institutions is exempt from U.S. income taxation if the interest is not effectively connected with the conduct of a U.S. trade or business.⁴³¹

3. Exception for “Portfolio Interest.”

a. Treatment of Portfolio Interest. U.S.-source “portfolio interest” received by a nonresident alien is not subject to the general 30% flat tax.⁴³² The same rule applies to portfolio interest received by a foreign corporation.⁴³³

b. Definition of “Portfolio Interest.” The term “portfolio interest” means non-exempt U.S. source interest (including original issue discount) which would otherwise be subject to the general 30% flat tax;⁴³⁴ and which is paid to a nonresident alien or foreign corporation on an obligation which meets either (1) a bearer obligation test or (2) a registered obligation test. As part of the 2010 Hiring Incentives to Restore Employment Act,⁴³⁵ Congress repealed the bearer obligation test for obligations issued after the date which is 2 years after March 18, 2010.⁴³⁶

(1) Bearer Obligation Test. The bearer obligation test is met if the obligation is not in registered form (i.e., bearer obligation) and the obligation meets certain

⁴²⁸I.R.C. §§ 871(a)(1)(C)(i), 881(a)(3)(A).

⁴²⁹I.R.C. § 871(g)(1)(B)(i).

⁴³⁰I.R.C. § 871(g)(1)(B)(ii).

⁴³¹I.R.C. §§ 871(i)(1), 871(i)(2)(A), 871(i)(3).

⁴³²I.R.C. § 871(h)(1); see Treas. Reg. § 1.871-14(a).

⁴³³I.R.C. § 881(c)(1); Treas. Reg. § 1.871-14(b).

⁴³⁴I.R.C. § 871(h)(2).

⁴³⁵Pub. L. No. 111-144, § 502(b)(1) 124 Stat. 42.

⁴³⁶See Notice 2012-20, 2012-13 I.R.B. 574 (“This notice provides guidance related to the repeal of section 163(f)(2)(B) of the Internal Revenue Code (Code) and related provisions enacted by section 502 of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147 (the HIRE Act).”).

prescribed conditions to ensure that such obligation is sold (or resold in connection with original issue) only to a person who is not a U.S. person.⁴³⁷

(2) Registered Obligation Test. An obligation meets the registered obligation test if the obligation is in registered form⁴³⁸ and either (i) the obligation is one with respect to which the U.S. person who would otherwise be required to withhold tax receives a statement that the beneficial owner of the obligation is not a U.S. person;⁴³⁹ or (ii) the obligation is targeted to foreign markets and the interest on such obligation is paid through financial institutions outside the United States.⁴⁴⁰

c. Exceptions and Special Rules. The term “portfolio interest” does not include the following:

(1) Interest that is effectively connected with the conduct by the foreign recipient of a U.S. trade or business;⁴⁴¹

(2) Interest on obligations issued on or before July 18, 1984;⁴⁴²

(3) Interest received by:

(a) A 10% or greater than 10% foreign shareholder of a U.S. corporate borrower;⁴⁴³ or

(b) A person owning 10% or more of the capital or profits of a U.S. partnership borrower;⁴⁴⁴

(4) Interest received by a related controlled foreign corporation;⁴⁴⁵

(5) Interest (other than interest on an obligation of the U.S.) received by foreign banks on obligations issued in the ordinary course of business;⁴⁴⁶ and

(6) Contingent interest.⁴⁴⁷

⁴³⁷I.R.C. §§ 871(h)(2)(A), 881(c)(2)(A), 163(f)(2)(B); see Treas. Reg. § 1.871-14(b)(1).

⁴³⁸I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B); see Treas. Reg. § 1.871-14(c)(1)(i).

⁴³⁹I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B); see Treas. Reg. § 1.871-14(c)(1)(ii)(C).

⁴⁴⁰See Treas. Reg. § 1.871-14(e)(1).

⁴⁴¹I.R.C. § 871(h)(2); Treas. Reg. § 1.871-14(a).

⁴⁴²Treas. Reg. § 1.871-14(b)(1).

⁴⁴³I.R.C. § 871(h)(3)(B)(i).

⁴⁴⁴I.R.C. § 871(h)(3)(B)(ii).

⁴⁴⁵I.R.C. § 881(c)(3).

⁴⁴⁶I.R.C. § 881(c)(3).

⁴⁴⁷I.R.C. § 871(h)(4).

4. Special Rule for Dividends from 80/20 Corporations. A portion of the dividends paid by a U.S. corporation meeting the 80% foreign business requirement (of I.R.C. § 861(c)(1)) is not subject to the 30% gross tax.⁴⁴⁸ The percentage of the dividends that are free of the 30% tax is determined as follows:

$$\frac{\text{Foreign source gross income of the U.S. corporation for the three prior years}}{\text{Total gross income of the U.S. corporation for the three prior years}}$$

A corporation generally meets the 80% foreign business requirement if, for the three prior tax years, at least 80% of the domestic corporation's gross income was (i) from a foreign source; and (ii) attributable to the active conduct of a trade or business in a foreign country.⁴⁴⁹

C. Other Items of Income Subject to 30% Flat Tax.

1. Certain Timber and Iron Ore Gains. Nonresident aliens and foreign corporations are subject to a 30% tax on gains derived from the disposal of timber, coal or domestic iron ore with a retained economic interest.⁴⁵⁰

2. Gains from Sale or Exchange of Certain Intangible Property. The 30% gross basis tax is imposed on gains derived by nonresident aliens and foreign corporations from the sale of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged.⁴⁵¹ The tax applies only to the extent the amount received is not effectively connected with the conduct of a U.S. trade or business.

D. Withholding of Tax on FDAP Income of Nonresident Aliens and Foreign Corporations.

1. Withholding Agents Required to Withhold 30% Tax. All persons (referred to as "withholding agents") having the control, receipt, custody, disposal, or payment of U.S.-sourced FDAP income of any nonresident alien or foreign partnership must deduct and withhold a 30% tax (or lesser rate imposed by an applicable income tax treaty⁴⁵²).⁴⁵³ The same obligation applies to withholding agents with respect to U.S.-source FDAP income of a foreign corporation.⁴⁵⁴

a. Withholding Obligation Applies to Payment of FDAP Income in Series of Repeated Payments or in a Single Lump Sum. The U.S. Treasury regulations provide that the term "fixed or determinable annual or periodical" income is merely descriptive

⁴⁴⁸I.R.C. §§ 871(i)(2)(B), 881(d).

⁴⁴⁹I.R.C. § 861(c)(1).

⁴⁵⁰I.R.C. §§ 871(a)(1)(B), 881(a)(2).

⁴⁵¹I.R.C. §§ 871(a)(1)(D), 881(a)(4).

⁴⁵²See Treas. Reg. § 1.1441-6.

⁴⁵³I.R.C. § 1441(a).

⁴⁵⁴I.R.C. § 1442(a).

of the character of a class of income. If an item of income is FDAP, it is “immaterial” whether payment of that item is made in a series of repeated payments or in a single lump sum.⁴⁵⁵

(1) Description of Fixed or Determinable Annual or Periodical Income. Under the Treasury regulations, income is “fixed” when it is to be paid in amounts definitely predetermined. Income is “determinable” whenever there is a basis of calculation by which the amount to be paid may be ascertained at a later time. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, necessarily prevent its being FDAP income. The fact that the length of time during which the payments are to be made may be increased or diminished in accordance with someone’s will or with the happening of an event does not make the payments any the less determinable or periodical.⁴⁵⁶

(2) Sales Income Is Not FDAP. The Regulations provide that income derived from the sale in the U.S. of real or personal property (with certain limited exceptions) is not FDAP income.⁴⁵⁷

2. Treatment of Domestic Partnerships with Nonresident Aliens and Foreign Corporations as Partners.

a. Withholding on Payments to Domestic Partnership with Foreign Partners. The regulations clarify that a payment to a person that the withholding agent may treat as a domestic partnership is treated as a payment to a U.S. payee.⁴⁵⁸ Therefore, if a U.S. withholding agent can reliably associate a Form W-9 provided by a U.S. partnership, the withholding agent may treat the payment as made to a U.S. payee and the payment is not subject to withholding under Section 1441 even though it may have partners that are foreign persons.

b. Withholding by U.S. Partnerships. Domestic partnerships are required to withholding on U.S.-source non-effectively connected FDAP income that is included in the distributive share of a member of such partnership who is a foreign person.⁴⁵⁹ A domestic partnership is required to withhold when any distributions that include amounts subject to

⁴⁵⁵Treas. Reg. § 1.1441-2(b)(1)(ii); *see also* Treas. Reg. § 1.1441-2(b)(1) (“For purposes of chapter 3 of the Code and the regulations thereunder, fixed or determinable annual or periodical income is all income included in gross income under section 61 (including original issue discount), except for the items specified in (b)(2) of this section.”). The general “theme” of the regulations is that “[a] withholding agent must withhold 30-percent of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to reduced withholding.” Treas. Reg. § 1.1441-1(b)(1). Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is one of the Forms W-8 or a Form 8233 (indicating foreign status of the payee or beneficial owner) or a Form W-9 (indicating U.S. status of the payee). Treas. Reg. § 1.1441-1(b)(2)(i).

⁴⁵⁶Treas. Reg. § 1.1441-2(b).

⁴⁵⁷Treas. Reg. § 1.1441-2(b)(2)(i).

⁴⁵⁸Treas. Reg. § 1.1441-5(b)(1).

⁴⁵⁹I.R.C. § 1441(b) (flush language); Treas. Reg. § 1.1441-5(b)(2)(i).

withholding (including guaranteed payments made by a U.S. partnership) are made.⁴⁶⁰ To the extent a foreign partner's distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership is required to withhold on the foreign partner's distributive share of the income on the earlier of the date that the Schedule K-1 is mailed or otherwise provided to the partner or the due date for furnishing the Schedule K-1.⁴⁶¹ If a partnership properly withholds on a foreign partner's undistributed share of U.S. source FDAP income, no withholding is required when the income is subsequently distributed.⁴⁶²

3. Treatment of Foreign Partnerships. A payment made to a foreign partnership may be treated as a payment made to the partners (if certain conditions are met) rather than to the partnership and the withholding agents must follow certain prescribed withholding procedures to determine the status of the payee partners.⁴⁶³ A withholding agent, however may treat a payment to a foreign partnership as made to the partnership (rather than to its partners) if, with respect to the partnership, certain requirements set forth in the regulations are met.⁴⁶⁴

4. Corporate Distributions.

a. Dividend Distributions. The withholding rules also apply to U.S.-source dividend income of nonresident aliens and foreign corporations, respectively.⁴⁶⁵

b. Other Distributions. A corporation making a distribution with respect to its stock is required to withhold on the entire amount of the distribution, unless it elects to reduce the amount of withholding.⁴⁶⁶ The amounts with respect to which a distributing corporation may elect to reduce the withholding include the following:

(1) A distributing corporation may elect to not withhold on a distribution to the extent it represents a nontaxable distribution payable in stock or stock rights;

(2) A distributing corporation may elect to not withhold on a distribution to the extent it represents a distribution in part or full payment for stock;

(3) A distributing corporation may elect to not withhold on a distribution (actual or deemed) to the extent it is not paid out of accumulated earnings and profits or current earnings and profits, based on a reasonable estimate (determined pursuant to a procedure in the regulations).⁴⁶⁷ A distributing corporation, however, that is a withholding agent with respect to a distribution and that determines at the end of the tax year in which the

⁴⁶⁰Treas. Reg. § 1.1441-5(b)(2)(i).

⁴⁶¹Treas. Reg. § 1.1441-5(b)(2)(i).

⁴⁶²Treas. Reg. § 1.1441-5(b)(2)(v).

⁴⁶³Treas. Reg. § 1.1441-5(c)(1).

⁴⁶⁴Treas. Reg. § 1.1441-5(c)(1)(ii).

⁴⁶⁵See Treas. Reg. § 1.1441-3(c)(1).

⁴⁶⁶Treas. Reg. § 1.1441-3(c)(1).

⁴⁶⁷Treas. Reg. § 1.1441-3(c)(2)(i)(C).

distribution is made that it underwithheld on the distribution is liable for the amount underwithheld.⁴⁶⁸

5. Exceptions and Exemptions from Withholding; Special Rules.

a. Foreign Source Income. Items of foreign-source income of a nonresident alien are not subject to withholding under Section 1441 or 1442.⁴⁶⁹

b. Income Effectively Connected with the Conduct of a U.S. Trade or Business. No withholding is required in the case of any item of income (other than certain compensation for personal services) which is effectively connected with the conduct of a trade or business and which is included in the gross income of the recipient as trade or business income.⁴⁷⁰ In order to avoid withholding, persons conducting U.S. trades or businesses are required to file a prescribed form (Form W-8ECI) with withholding agents for each tax year for which such persons will be entitled to the income, and before payment of the income in respect of which it applies.⁴⁷¹

c. Treatment of Compensation for Services.

(1) Services Performed by a Foreign Partnership or a Foreign Corporation. Subject to application of a *de minimis* rule in Section 864(b)(1), a foreign partnership or foreign corporation that performs services in the U.S. is generally treated as engaged in the conduct of a U.S. trade or business and any income arising therefrom is treated as effectively connected income.⁴⁷² No withholding is required with respect to income for services performed by a foreign partnership or a foreign corporation (other than a foreign corporation which has certain income derived from a personal service contract).⁴⁷³

(2) Services Performed by an Individual. Compensation for personal services performed by a nonresident alien within the U.S. is generally subject to withholding, unless that compensation is specifically exempted from withholding (e.g., by treaty) or is subject to graduated withholding applicable to employees.⁴⁷⁴

6. Liability for Withholding Tax. Every withholding agent is personally liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made to the Government.⁴⁷⁵

7. Reporting Requirements.

⁴⁶⁸Treas. Reg. § 1.1441-3(c)(2)(ii)(B).

⁴⁶⁹Treas. Reg. § 1.1441-1(b)(4)(v).

⁴⁷⁰I.R.C. § 1441(c)(1); Treas. Reg. § 1.1441-4(a)(1).

⁴⁷¹Treas. Reg. § 1.1441-4(a)(2).

⁴⁷²I.R.C. § 864(b).

⁴⁷³Treas. Reg. § 1.1441-4(a)(1); *see* Treas. Reg. § 1.1441-4(a)(2)(i) (addresses withholding agent's reliance on a claim of effectively connected income).

⁴⁷⁴Treas. Reg. § 1.1441-4(b)(1).

⁴⁷⁵I.R.C. § 1461.

a. Form 1042. Every withholding agent is generally required to file Form 1042 on or before March 15 reporting the tax required to be withheld during the preceding calendar year. Even if no tax was withheld by the withholding agent, Form 1042 is nevertheless required to be filed if the withholding agent was required to prepare a Form 1042S with respect to any payments made during the year.⁴⁷⁶ Withholding agents are required to transmit with the Form 1042 all Forms 1042S prepared during the previous year.⁴⁷⁷

b. Form 1042S. Every withholding agent is required to prepare before March 15 a 1042S showing all income items paid during the preceding calendar year to nonresident aliens, foreign partnerships, nonresident alien or foreign fiduciaries of a trust or estate, or foreign corporations if such items consist of amounts subject to withholding.⁴⁷⁸ A copy of the Form 1042S must be provided to the recipient.⁴⁷⁹

8. Withholding Tax as Credit to Recipient of Income. The entire amount of income from which tax is required to be withheld must be included in gross income on the “return required to be made by the recipient,” without deduction for the withheld amount, but the tax so withheld is allowed as a credit against the total income tax computed in the taxpayer’s return.⁴⁸⁰

E. Obtaining Reduced Treaty Withholding Rates. The Treasury Regulations provide that the general withholding rate of 30 percent must be reduced as may be provided by an income tax treaty with any country. The regulations prescribe the method for securing the reduced withholding rate.⁴⁸¹

F. Reporting of Bank Deposit Interest. Sections 1.6049-4(b)(5) and 1.6049-8 of the Income Tax Regulations, as revised by TD 9584, require the reporting of certain deposit interest paid to nonresident alien individuals on or after January 1, 2013.⁴⁸² The regulations provide that in the case of reportable interest aggregating \$10 or more paid to a nonresident alien individual (as defined in section 7701(b)(1)(B) of the Internal Revenue Code), the payor shall make an information return on Form 1042-S for the calendar year in which the interest is paid.

⁴⁷⁶Treas. Reg. § 1.1461-1(b)(1); *see also Northern Indiana Pub. Serv. Co. v. Commissioner*, 101 T.C. 294 (1993) (special 6-year statute of limitations contained in I.R.C. § 6501(e)(1) applies where there is an omission of gross income paid to nonresident aliens that exceeds 25% of the amount shown on Form 1042); GCM 39,888 (April 20, 1995) (substantial understatement penalty applies to Form 1042).

⁴⁷⁷Treas. Reg. § 1.1461-1(c)(1).

⁴⁷⁸Treas. Reg. § 1.1461-1(c)(2).

⁴⁷⁹Treas. Reg. § 1.1461-1(c)(1)(i).

⁴⁸⁰I.R.C. § 1462.

⁴⁸¹Treas. Reg. § 1.1441-6(a); *but see* I.R.C. § 894(c) enacted in 1997 (foreign person is entitled to reduced withholding under a treaty with a foreign country on an item of income derived through an entity that is a partnership (or is otherwise treated as transparent) for U.S. tax purposes only if such item is treated for purposes of the tax laws of such country as an item of income of such person); *see also* Treas. Reg. § 1.894-1(d)(i) (“The tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction.”).

⁴⁸²Treas. Reg. § 1.6049-4(b)(5)(ii); Treas. Reg. § 1.6049-8(a).

Reportable interest is interest on deposits with banks, certain savings institutions and certain amounts held by insurance companies under agreements to pay interest thereon⁴⁸³ and that (1) relates to a deposit maintained at an office within the United States, and (2) is paid to a nonresident alien individual who is a resident of a country identified, in an applicable revenue procedure as of December 31 prior to the calendar year in which the interest is paid, as a country with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of information pursuant to which United States agrees to provide, as well as receive, information and under which the competent authority is the Secretary of the Treasury or his delegate.⁴⁸⁴

The Service has issued Rev. Proc. 2014-64,⁴⁸⁵ as supplemented by Rev. Proc. 2015-50,⁴⁸⁶ as further supplemented by Rev. Proc. 2016-18,⁴⁸⁷ to list the countries with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of information pursuant to which the United States agrees to provide, as well as receive, information and under which the competent authority is the Secretary of the Treasury or his delegate. Rev. Proc. 2014-64 states that “[a]s noted in the preamble to the regulations and Rev. Proc. 2012-24, the IRS is not required to exchange information with another country, even if an information exchange agreement is in effect, if there are concerns about confidentiality, safeguarding of data exchanged, the use of the information, or other factors that would make the exchange of information inappropriate.” Rev. Proc. 2014-64 also identifies the countries with which the Treasury Department and the IRS have determined that it is appropriate to have an automatic exchange relationship with respect to the information collected under the regulations.

G. Expansion of Information Reporting Requirements on Foreign Financial Institutions.

1. March 18, 2010: HIRE Act Adds New Chapter 4. On March 18, 2010, the Hiring Incentives to Restore Employment Act of 2010⁴⁸⁸ (the “HIRE Act”) was enacted into law. The HIRE Act added a new Chapter 4 (new sections 1471–1474) to Subtitle A of the Internal Revenue Code. These sections expand the information reporting requirements imposed on foreign financial institutions (as defined in Section 1471(d)(4) (“FFIs”) with respect to certain United States accounts (as defined in section 1471(d)(1)) (“U.S. accounts”).⁴⁸⁹ Chapter 4 requires withholding agents to withhold 30 percent of certain payments to an FFI unless the FFI has entered into an agreement with the IRS to, among other things, report certain information with respect to U.S. accounts.⁴⁹⁰ Chapter 4 also imposes on withholding agents certain withholding, documentation, and reporting requirements with respect to certain payments made

⁴⁸³I.R.C. § 871(a)(2)(A).

⁴⁸⁴Treas. Reg. § 1.6049-8.

⁴⁸⁵2014-64, 2014-53 I.R.B. 1022.

⁴⁸⁶2015-42 IRB 583.

⁴⁸⁷2016-17 IRB 635.

⁴⁸⁸Pub. L. No. 111-147, 124 Stat. 71.

⁴⁸⁹See generally I.R.C. Sec. 1471.

⁴⁹⁰I.R.C. Sec. 1471(a).

to certain other foreign entities. Chapter 4 also imposes withholding, documentation, and reporting requirements with respect to certain payments made to certain foreign entities.⁴⁹¹

2. February 8, 2012: U.S. Treasury Department and IRS Publish Proposed Regulations Under Chapter 4. On February 8, 2012, the Treasury Department and the IRS published proposed regulations under chapter 4 in the Federal Register (REG-121647-10, 77 Fed. Reg. 9022).

3. February 8, 2012: Treasury Announces Intergovernmental Framework for FATCA Implementation. On February 8, 2012, the U.S. Treasury Department issued a “Joint Statement from the United States, France, Germany, Italy, Spain and the United Kingdom Regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA” (“Joint Statement”).⁴⁹² The Joint Statement states as follows:

A. General Considerations

1. Building on their longstanding and close relationship with respect to mutual assistance in tax matters, the United States, France, Germany, Italy, Spain and the United Kingdom wish to intensify their co-operation in combating international tax evasion.

2. On 18 March 2010 the United States enacted provisions commonly referred to as the Foreign Account Tax Compliance Act (FATCA), which introduce reporting requirements for foreign financial institutions (FFIs) with respect to certain accounts. France, Germany, Italy, Spain and the United Kingdom are supportive of the underlying goals of FATCA. FATCA, however, has raised a number of issues, including that FFIs established in these countries may not be able to comply with the reporting, withholding and account closure requirements because of legal restrictions.

3. An intergovernmental approach to FATCA implementation would address these legal impediments to compliance, simplify practical implementation, and reduce FFI costs.

4. Because the policy objective of FATCA is to achieve reporting, not to collect withholding tax, the United States is open to adopting an intergovernmental approach to implement FATCA and improve international tax compliance.

5. In this regard the United States is willing to reciprocate in collecting and exchanging on an automatic basis information on accounts held in US financial institutions by residents of France, Germany, Italy, Spain and the

⁴⁹¹See I.R.C. Sec. 1472(b).

⁴⁹²See “Treasury Announces Intergovernmental Framework for FATCA, 2012 TNT 27-28. Since the date Treasury made this announcement, other countries have issued similar joint statements with Treasury.

United Kingdom. The approach under discussion, therefore, would enhance compliance and facilitate enforcement to the benefit of all parties.

6. The United States, France, Germany, Italy, Spain and the United Kingdom are cognizant of the need to keep compliance costs as low as possible for financial institutions and other stakeholders and are committed to working together over the longer term towards achieving common reporting and due diligence standards.

7. In light of these considerations, the United States, France, Germany, Italy, Spain and the United Kingdom have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange and based on existing bilateral tax treaties.

B. Possible Framework for Intergovernmental Approach

1. The United States and a partner country (FATCA partner) would enter into an agreement pursuant to which, subject to certain terms and conditions, the FATCA partner would agree to:

a. Pursue the necessary implementing legislation to require FFIs in its jurisdiction to collect and report to the authorities of the FATCA partner the required information;

b. Enable FFIs established in the FATCA partner (other than FFIs that are excepted pursuant to the agreement or in U.S. guidance) to apply the necessary diligence to identify US accounts; and

c. Transfer to the United States, on an automatic basis, the information reported by the FFIs.

2. In consideration of the foregoing, the United States would agree to:

a. Eliminate the obligation of each FFI established in the FATCA partner to enter into a separate comprehensive FFI agreement directly with the IRS, provided that each FFI is registered with the IRS or is excepted from registration pursuant to the agreement or IRS guidance;

b. Allow FFIs established in the FATCA partner to comply with their reporting obligations under FATCA by reporting information to the FATCA partner rather than reporting it directly to the IRS;

c. *Eliminate U.S. withholding under FATCA on payments to FFIs established in the FATCA partner (i.e., by identifying all FFIs in the FATCA partner as participating FFIs or deemed-compliant FFIs, as appropriate);*

d. *Identify in the agreement specific categories of FFIs established in the FATCA partner that would be treated, consistent with IRS guidelines, as deemed compliant or presenting a low risk of tax evasion;*

e. *Commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information on the U.S. accounts of residents of the FATCA partner.*

3. In addition, as a result of the agreement with the FATCA partner described above, FFIs established in the FATCA partner would not be required to:

a. *Terminate the account of a recalcitrant account holder;*

b. *Impose passthru payment withholding on payments to recalcitrant account holders;*

c. *Impose passthru payment withholding on payments to other FFIs organized in the FATCA treaty partner or in another jurisdiction with which the United States has a FATCA implementation agreement.*

4. The United States, France, Germany, Italy, Spain and the United Kingdom would:

a. *Commit to develop a practical and effective alternative approach to achieve the policy objectives of passthru payment withholding that minimizes burden.*

b. *Commit to working with other FATCA partners, the OECD, and where appropriate the EU, on adapting FATCA in the medium term to a common model for automatic exchange of information, including the development of reporting and due diligence standards.*

4. May 15, 2012: IRS Holds Public Hearing on Proposed Regulations.

On May 15, 2012, the IRS held a public hearing on the proposed regulations.⁴⁹³

⁴⁹³See “Unofficial Transcript Available of IRS Hearing on FATCA,” 2012 TNT 95-28.

5. July 26, 2012: U.S. Treasury Department Releases First Model For Bilateral Agreements with Other Jurisdictions. On July 26, 2012, the Treasury Department released a model for bilateral agreements (“Model 1”) with other jurisdictions (in both reciprocal⁴⁹⁴ and nonreciprocal versions⁴⁹⁵) under which FFIs would satisfy their chapter 4 requirements by reporting information about U.S. accounts to their respective tax authorities, followed by the automatic exchange of that information on a government-to-government basis with the United States. The model agreement outlines time frames for FFIs in partner jurisdictions to complete the necessary due diligence to identify U.S. accounts.

6. October 24, 2012: IRS Announces Modification of Certain FATCA Timelines. On October 24, 2012, the IRS announced (i) certain timelines for withholding agents and FFIs to complete due diligence and other requirements and (ii) certain additional guidance concerning gross proceeds withholding and the status of certain instruments as grandfathered obligations under sections 1471 through 1474 of the Internal Revenue Code (Code).⁴⁹⁶

7. November 14, 2012: Treasury Releases a Second Model Intergovernmental Agreement for Implementation of FATCA. On November 14, 2012, the Treasury Department released a second model agreement (“Model 2”), under which financial institutions in the partner jurisdiction would report specified information directly to the IRS, supplemented by government-to-government exchange of information on request.⁴⁹⁷

8. November 19, 2012: U.S. and Mexico Sign FATCA Agreement. On November 19, 2012, the U.S. and Mexico announced the execution of a bilateral agreement for the implementation of FATCA.⁴⁹⁸ The agreement with Mexico is based on the Model 1 template.⁴⁹⁹

9. January 28, 2013: IRS Issues Final FATCA Regulation. On January 13, 2013, the IRS issued final regulation under Section 1471 through 1474 of the Code.⁵⁰⁰

⁴⁹⁴See “FATCA Reciprocal Model Agreement Available,” 2012 TNT 145-28.

⁴⁹⁵See “FATCA Nonreciprocal Model Agreement Available,” 2012 TNT 145-29.

⁴⁹⁶Ann. 2012-42, 2012 TNT 207-9.

⁴⁹⁷See “Treasury Releases FATCA Model II Agreement,” 2012 TNT 222-1; Model 2 Template, “Treasury Releases Model II Agreement to Implement FATCA,” 2012 TNT 222-15.

⁴⁹⁸See “Mexico-U.S. FATCA Agreement is Available,” 2012 TNT 229-43.

⁴⁹⁹See “U.S., Mexico Sign FATCA Agreement,” 2012 TNT 229-4.

⁵⁰⁰T.D. 9610, 2013-15 IR.B. 765, *reprinted at* 2013 TNT 13-6.

CHAPTER XI: SPECIAL TAX CONSIDERATIONS PERTAINING TO OWNERSHIP AND DISPOSITION OF U.S. REAL ESTATE BY FOREIGN PERSONS

A. Background and General Pattern of Taxation.

1. **Background.** Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act (“FIRPTA”). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. tax on the eventual disposition of such property.

2. **General Pattern of Taxation.** The U.S. income tax rules which apply to income derived by a foreign person from U.S. real property are essentially the same as the normal rules which apply to income derived by a foreign person from U.S. sources. Accordingly, foreign persons owning U.S. real estate are generally subject to U.S. taxation either on a gross basis on noneffectively connected income or on a net basis if they have effectively connected income.

B. Election to Treat All Income from U.S. Real Estate as U.S. Trade or Business Income. A foreign person may elect to treat all income from U.S. real property interests as income which is effectively connected with the conduct of a trade or business in the U.S. (the “Code net election”). The Code and treaty provisions which contain such an election provide that the election applies to all U.S. real property and all income from such property.⁵⁰¹ The Code net election (and frequently the treaty net elections) applies not only to rental income but also to royalties from mines, wells and other natural deposits as well as to gains from certain sales of timber, coal or iron ore.⁵⁰² The Code net election may not be made by a foreign person in a taxable year in which such foreign person has no income from U.S. real property, or from any interest in such property, which is subject to the 30-percent withholding tax.⁵⁰³ The Code net election does not result in a foreign person being considered engaged in a U.S. trade or business; rather, only the income (and deductions) from the U.S. real property is treated as income which is effectively connected with the conduct of a trade or business within the United States.⁵⁰⁴ Once made, the Code net election is irrevocable unless the IRS consents to a revocation of the election.⁵⁰⁵

C. Treatment of Dispositions of U.S. Real Property Interests by Foreign Persons. Gain or loss of a foreign person from the disposition of a U.S. real property interest is

⁵⁰¹See I.R.C. §§ 871(d)(1), 882(d)(1).

⁵⁰²I.R.C. §§ 871(d)(1)(A), 882(d)(1)(A).

⁵⁰³Treas. Reg. § 1.871-10(a); see Rev. Rul. 91-7, 1991-1 C.B. 110 (“A nonresident alien individual or foreign corporation may not make an election under section 266 of the Code to capitalize real estate taxes, mortgage interest, and other carrying charges attributable to unimproved and unproductive U.S. real property if, during the taxable year in which such expenses are incurred, such expenses are not allowable deductions under section 873(a) or 882(c).”).

⁵⁰⁴Treas. Reg. § 1.871-10(e)(1).

⁵⁰⁵I.R.C. §§ 871(d)(3), 882(d)(2); Treas. Reg. § 1.871-10(d)(2)(iii); Treas. Reg. § 1.882-2(a).

deemed to be effectively connected with the conduct of a U.S. trade or business.⁵⁰⁶ Losses of nonresident alien individuals are taken into account under these provisions only to the extent that such losses would be taken into account under Code section 165(c), (which limits loss deductions to business losses, losses on transactions entered into for profit, and certain casualty or theft losses).⁵⁰⁷ In the case of nonresident alien individuals, the alternative minimum tax applies to the lesser of the individual's alternative minimum taxable income or the individual's net real property gains.⁵⁰⁸

1. Definition of "U.S. Real Property Interest." The term "U.S. real property interests" ("USRPI") means (i) any interest in real property (including an interest in a mine, well, or other natural deposit) located in the U.S. or the Virgin Islands, or (ii) any interest (other than any interest solely as a creditor) in a domestic corporation, unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the shorter of (i) the period during which the taxpayer held such interest, or (ii) the five-year period ending on the date of the disposition of the interest.⁵⁰⁹

a. Definition of "Real Property" and "Interest in Real Property." The term "real property" includes land and unsevered natural products of the land, improvements and personal property associated with the use of real property.⁵¹⁰ The term "interest in real property" includes (i) a fee ownership, co-ownership or leasehold interest in real property;⁵¹¹ (ii) options to acquire land or improvement thereon and options to acquire leaseholds;⁵¹² (iii) partial interests in real property, such as life estates, remainders, and reversions;⁵¹³ and (iv) any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property.⁵¹⁴

b. Definition of U.S. Real Property Holding Corporation. A corporation is a U.S. real property holding corporation ("USRPHC") if the fair market value of its USRPIs equals or exceeds fifty percent of the sum of the fair market values of its:

- (1) USRPIs;
- (2) Interests in foreign real property; and

⁵⁰⁶I.R.C. § 897.

⁵⁰⁷I.R.C. § 897(b).

⁵⁰⁸I.R.C. § 897(a)(2)(A).

⁵⁰⁹I.R.C. § 897(c)(1)(A)(ii). A special rule applies to publicly-traded USRPHC stock. USRPHC stock of a class that is regularly traded on an established securities market is treated as a U.S. real property interest only in the case of a foreign person that, at some time during the five-year prescribed testing period, held more than 5 percent of that class of stock. I.R.C. § 897(c)(3).

⁵¹⁰Treas. Reg. § 1.897-1(b)(1).

⁵¹¹Treas. Reg. § 1.897-1(d)(2)(i).

⁵¹²See Treas. Reg. § 1.897-1(d)(2)(i); Treas. Reg. § 1.897-1(d)(2)(ii)(B).

⁵¹³Treas. Reg. § 1.897-1(d)(2)(i).

⁵¹⁴Treas. Reg. § 1.897-1(d)(2)(i).

(3) Any other assets which are used or held for use in a trade or business.⁵¹⁵

For purposes of this asset test, a corporation that is a partner in a partnership or a beneficiary of an estate or trust generally takes into account its proportionate share of all assets of such partnership, estate or trust.⁵¹⁶ Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in another corporation, whether foreign or domestic.⁵¹⁷

USRPHC status is important for determining whether gain from the disposition by a foreign person of an interest in a domestic corporation is taxable. Such status is also important for purposes of the withholding requirements of Section 1445.

If a corporation qualifies as a USRPHC, then any interest in it is treated as a USRPI for a period of five years from that date, unless such corporation disposes of all of its USRPIs in taxable dispositions.⁵¹⁸ The fair market value of a corporation's USRPIs is presumed to be less than fifty percent of the fair market value of the assets described above if the total book value of such USRPIs is twenty-five percent or less of the book value of the aggregate of the corporation's assets.⁵¹⁹

c. Treatment of Interests in Partnerships Owning U.S. Real Property Interests. Gain recognized by a foreign person on the disposition of an interest in a partnership, trust, or estate generally is subject to tax under Section 897 to the extent that the gain is attributable to any appreciation in the value of any U.S. real property interests of the entity.⁵²⁰ Under the Treasury Regulations, an interest in a partnership in which, directly or indirectly, fifty percent or more of the value of the gross assets consist of USRPIs, and ninety percent or more of the value of the gross assets consist of USRPIs plus any cash or cash equivalents is treated entirely as a USRPI for purposes of the withholding provisions of Section 1445.⁵²¹ On the other hand, such interest is treated as a USRPI for purposes of determining the gain from the disposition of a USRPI only to the extent that the gain on the disposition is attributable to USRPIs.⁵²² Thus, the disposition of any portion of a partnership interest is subject to partial taxation under Section 897(a) and full withholding under Section 1445(a).

2. Application of Nonrecognition Provisions. For purposes of Section 897, nonrecognition provisions apply under Section 897 only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code.⁵²³ This rule

⁵¹⁵I.R.C. § 897(c)(2).

⁵¹⁶I.R.C. § 897(c)(4)(B).

⁵¹⁷I.R.C. § 897(c)(5).

⁵¹⁸Treas. Reg. § 1.897-2(b); Treas. Reg. § 1.897-2(f).

⁵¹⁹Treas. Reg. § 1.897-2(b)(2); see Treas. Reg. § 1.897-1(o) for methods of determining the fair market value of assets.

⁵²⁰I.R.C. § 897(g).

⁵²¹Treas. Reg. § 1.897-7T.

⁵²²I.R.C. § 897(g).

⁵²³I.R.C. § 897(e)(1).

is designed to prevent a foreign person from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code.⁵²⁴ Moreover, gain generally is recognized by a foreign person under Section 897 on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as contribution to capital.⁵²⁵

3. Section 897(i) Election. If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions.⁵²⁶ This election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under Section 897 will be taxable even if such taxation would be contrary to a treaty.⁵²⁷ This election to be treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of the FIRPTA provisions.⁵²⁸

4. PATH Act Amendments. Section 323(a) of the PATH Act added section 897(l), which provides that section 897 does not apply (i) to USRPIs held directly (or indirectly through one or more partnerships) by, or (ii) to distributions received from a real estate investment trust by, a qualified foreign pension fund or an entity wholly owned by a qualified foreign pension fund. Section 897(l)(2) defines a qualified foreign pension fund for purposes of section 897(l), and section 897(l)(3) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 897(l). In addition, section 323(b) of the PATH Act amended the definition of foreign person in section 1445(f)(3) to provide that entities described in section 897(l) are not treated as foreign persons for purposes of section 1445, except as otherwise provided by the Secretary. The amendments in section 323 of the PATH Act are applicable to dispositions and distributions after December 18, 2015.

D. Withholding on Disposition of U.S. Real Property Interests.

1. General Withholding Requirement. In general, a transferee, foreign or domestic, of a foreign person's USRPI is required to deduct and withhold a tax equal to 15%⁵²⁹ of the amount realized on the disposition.⁵³⁰ The "amount realized" is the sum of (i) the cash paid or to be paid, (ii) the fair market value of other property transferred, or to be transferred, and

⁵²⁴Staff of the Joint Comm. on Taxation, 104th Cong., 2d Sess., *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS-5-96) (1996).

⁵²⁵I.R.C. § 897(j).

⁵²⁶I.R.C. § 897(i).

⁵²⁷I.R.C. § 897(i)(3)(A).

⁵²⁸I.R.C. § 897(i)(4).

⁵²⁹The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), P.L. 114-113, § 324(a), substituted 15% for 10% in I.R.C. § 1445(a), effective for dispositions after the date which is 60 days after December 18, 2015. Section 324(b) of the PATH Act, however, retained the 10-percent withholding rate in the case of a disposition of property that is acquired by the transferee for his or her use as a residence with respect to which the amount realized is greater than \$300,000 but does not exceed \$1 million.

⁵³⁰I.R.C. § 1445(a).

(iii) the outstanding amount of any liability assumed by the transferee or to which the USRPI is subject immediately before and after the transfer.⁵³¹

2. Reporting and Payment Requirement. A transferee of a USRPI is required to report and send to the IRS any taxes withheld by the 20th day after the date of transfer.⁵³² If (i) an application for a Withholding Certificate was sent to the IRS on or before the date of transfer by the transferor or transferee, and (ii) the principal purpose of filing the application for Withholding Certificate was not for the purpose of delaying payment to the IRS, then the transferee must still withhold tax but need not remit withheld taxes to the IRS until the 20th day after the IRS' final determination regarding the application for withholding certificate.⁵³³

3. Liability of Transferee. A transferee may be held personally liable for the failure to comply with the withholding provisions.⁵³⁴ If a transferee is required to deduct and withhold tax under section 1445 but fails to do so, and the transferor's tax liability with respect to the transfer was satisfied (or was established to be zero) by (1) the transferor's filing of an income tax return (and payment of any tax due) with respect to the transfer, or (2) the issuance of a withholding certificate by the Internal Revenue Service establishing that the transferor's maximum tax liability is zero, then the regulations provide that the tax required to be withheld under section 1445 will not be collected from the transferee.⁵³⁵ The regulations provide, however, that the transferee will be held liable for interest (for the period prescribed in the regulations).⁵³⁶

E. Exemptions and Special Rules.

1. Purchase of Residence for \$300,000 or Less. If a transferee is acquiring a residence for use as a residence, and the amount realized by the transferor is \$300,000 or less, then no withholding is required.⁵³⁷

2. Notice of Nonrecognition. No withholding is required if the transferor provides notice to the transferee that a nonrecognition provision exempts the gain or loss on the transfer. The notice must be given to the IRS by the 20th day after the date of transfer.⁵³⁸

3. Stock Regularly Traded on Established Securities Market. No withholding is required if the disposition is of a share of a class of stock that is regularly traded on an established securities market.⁵³⁹

⁵³¹Treas. Reg. § 1.1445-1(g)(5).

⁵³²Treas. Reg. § 1.1445-1(c)(1).

⁵³³Treas. Reg. § 1.1445-1(c)(2)(i)(B).

⁵³⁴I.R.C. §§ 1461, 6672; Treas. Reg. § 1.1445-1(e).

⁵³⁵Treas. Reg. § 1.1445-1(e)(3)(ii).

⁵³⁶Treas. Reg. § 1.1445-1(e)(3)(iii).

⁵³⁷I.R.C. § 1445(b)(5).

⁵³⁸Treas. Reg. § 1.1445-2(d).

⁵³⁹I.R.C. § 1445(b)(6).

4. Non-USRPHC Affidavit. No withholding is required if the transferor provides to the transferee a statement that the interest is not a USRPI.⁵⁴⁰

5. Nonforeign Affidavit. No withholding is required if the transferor provides to the transferee an affidavit stating, under penalties of perjury, the transferor's U.S. taxpayer identification number and that the transferor is not a foreign person.⁵⁴¹

On August 5, 2003, the Service issued new Treas. Reg. § 1.1445-2(b)(2)(iii), which provides that a disregarded entity may not certify that it is the transferor of a U.S. real property interest as the disregarded entity is not the transferor for U.S. tax purposes. Rather, the owner of the disregarded entity is treated as the transferor and must provide a certificate of non-foreign status to avoid withholding under Section 1445. Any domestic entity must include in its certification of non-foreign status with respect to the transfer of U.S. real estate a certification that it is not a disregarded entity.

6. Options, Installment Sales and Foreclosures. Special rules are provided in the Regulations for options,⁵⁴² installment sales⁵⁴³ and foreclosures.⁵⁴⁴

7. Withholding Certificates. Withholding under Section 1445(a) may be reduced or eliminated pursuant to a withholding certificate issued by the Service in accordance with the rules of Treas. Reg. § 1.1445-3(a).

F. Withholding Rules for Corporations, Partnerships, Trusts or Estates. The U.S. generally requires domestic partnerships, domestic trusts, and domestic estates to withhold an amount equal to 35% (or to the extent provided in regulations 20%) of the gain realized from sales of U.S. real property interests that are allocable to foreign persons.⁵⁴⁵ A 35% withholding tax is imposed on certain distributions by foreign corporations.⁵⁴⁶ A 15% withholding tax is imposed on distributions by certain domestic corporations to foreign shareholders.⁵⁴⁷

G. Service Issues Final Regulations Requiring Foreign Transferors to Provide Taxpayer Identification Numbers. On August 5, 2003, the Internal Revenue Service issued final regulations that require foreign transferors of U.S. real property interests (and transferees where applicable) to provide their taxpayer identifying numbers (TINs) on withholding tax returns, applications for withholding certificates, and other notices and elections under sections

⁵⁴⁰I.R.C. §§ 1445(b)(3), 1445(b)(7).

⁵⁴¹I.R.C. §§ 1445(b)(2), 1445(b)(7).

⁵⁴²See Treas. Reg. § 1445-1(b)(3).

⁵⁴³See Treas. Reg. § 1.1445-2(d)(4); Rev. Proc. 2000-35, 2002-2 C.B. 211.

⁵⁴⁴See Treas. Reg. § 1.1445-2(d)(3).

⁵⁴⁵I.R.C. § 1445(e)(1).

⁵⁴⁶I.R.C. § 1445(e)(2).

⁵⁴⁷I.R.C. § 1445(e)(3). The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), P.L. 114-113, § 324(a), substituted 15% for 10% in I.R.C. § 1445(a), effective for dispositions after the date which is 60 days after December 18, 2015. Section 324(b) of the PATH Act, however, retained the 10-percent withholding rate in the case of a disposition of property that is acquired by the transferee for his or her use as a residence with respect to which the amount realized is greater than \$300,000 but does not exceed \$1 million.

897 and 1445 and the regulations thereunder.⁵⁴⁸ This requirement is effective for dispositions occurring after November 3, 2003.⁵⁴⁹

⁵⁴⁸T.D. 9082, 2003-2 C.B. 807; *see, e.g.*, Treas. Reg. § 1.1445-1(c)(1).

⁵⁴⁹*Ibid.*

CHAPTER XII: SELECTED U.S. PAYROLL TAX ISSUES RELATING TO NONRESIDENT ALIENS

A. FICA.

1. General Statutory Authority for FICA Tax Liability. A tax is imposed on both employers⁵⁵⁰ and employees⁵⁵¹ under the Federal Insurance Contributions Act (“FICA”) for social security (old-age, survivors and disability insurance - “OASDI”) and hospital insurance purposes. The FICA tax rate and maximum wage base subject to tax for 2016 are as follows:

Tax Rate	Maximum Earnings Base	Maximum Tax on Employee	Maximum Tax on Employer
For 2016, employee OASDI rate is 6.2%; employer OASDI rate is 6.2% ⁵⁵²	\$118,500 ⁵⁵³	\$7,347	\$7,347
1.45%(HI)	No limit	No limit	No limit

For tax years beginning after December 31, 2012, the Code imposes on every taxpayer (other than a corporation, estate or trust) a tax equal to .9% of wages which are in excess of (1) in the case of a joint return, \$250,000; (2) in the case of a married taxpayer filing a separate return, ½ of the dollar amount determined under (1); and (3) in any other case, \$200,000.⁵⁵⁴

The term “wages” with certain enumerated exceptions, generally means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.⁵⁵⁵ The term “employment” generally includes any service, of whatever nature, by an employee for his employer, irrespective of the citizenship or residence of either, within the United States.⁵⁵⁶

⁵⁵⁰See I.R.C. § 3111.

⁵⁵¹See I.R.C. § 3101.

⁵⁵²I.R.C. § 3101(a); P.L. 111-312, §§ 601(a)(2), 601(c) (as amended by P.L. 112-96, § 1001(a)).

⁵⁵³SSA Notice, 80 Fed. Reg. 66,693 (Oct. 30, 2015).

⁵⁵⁴I.R.C. § 3101(b)(2).

⁵⁵⁵I.R.C. § 3121(a).

⁵⁵⁶I.R.C. § 3121(b).

2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.

a. Wages Paid by U.S. Person/Employer. FICA taxes must generally be withheld on wages paid by a U.S. person/employer to a nonresident alien employee for work performed within the U.S. In addition, the employer is generally subject to FICA taxes for the wages paid.⁵⁵⁷

b. Wages Paid by Foreign Person/Employer. FICA taxes must generally be withheld on wages paid by a foreign person/employer to a nonresident alien employee for work performed within the U.S. In addition, the foreign person/employer is generally subject to FICA taxes for the wages paid.⁵⁵⁸

3. Exception to Liability for Persons in Certain Visa Categories. Exceptions to the general liability rules apply to persons in the U.S. under certain visa categories, including A (employees of foreign governments)⁵⁵⁹, F (student)⁵⁶⁰, G (certain employees of international organizations)⁵⁶¹, J (exchange visitors)⁵⁶², M (nonacademic students)⁵⁶³ and Q (international cultural exchange visitors)⁵⁶⁴ visas. Notably, services performed by a nonresident alien individual who is temporarily present in the U.S. under F, J, M or Q visa status are exempted from the FICA requirement if the services are performed to carry out the purpose for which the individual was admitted to the U.S.⁵⁶⁵

4. Impact of Totalization Agreements. A nonresident alien's liability for FICA taxes may be modified by an applicable totalization agreement between the U.S. and the country in which the individual is a resident.

B. FUTA.

1. General Statutory Authority for FUTA Tax Liability. A tax is also imposed on employers under the Federal Unemployment Tax Act.⁵⁶⁶ The tax rate is equal to 6.2-percent (through 2010 and the first 6 months of calendar year 2011; changing to 6.0 percent in the case of the remainder of calendar year 2011 and each calendar year thereafter⁵⁶⁷) of the taxable wages paid by the employer during the calendar year.⁵⁶⁸ The FUTA tax applies to the

⁵⁵⁷Rev. Rul. 92-106, 1992-2 C.B. 258, 260.

⁵⁵⁸*Ibid.*

⁵⁵⁹I.R.C. § 3121(b)(11).

⁵⁶⁰I.R.C. § 3121(b)(19).

⁵⁶¹I.R.C. § 3121(b)(15).

⁵⁶²I.R.C. § 3121(b)(19).

⁵⁶³I.R.C. § 3121(b)(19).

⁵⁶⁴I.R.C. § 3121(b)(19).

⁵⁶⁵I.R.C. § 3121(b)(19); *see* Treas. Reg. § 31.3121(b)(19)-1(a)(1).

⁵⁶⁶I.R.C. § 3301.

⁵⁶⁷I.R.C. § 3301(2) (as amended by P.L. 111-92, § 10(a)).

⁵⁶⁸I.R.C. § 3301.

first \$7,000 in wages paid to each employee annually.⁵⁶⁹ An employer generally may deduct FUTA taxes and the employer's share of FICA taxes as an ordinary and necessary business expense (assuming the payment of such taxes meets the ordinary and necessary business expense tests).⁵⁷⁰

"Wages," with certain exceptions, is all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.⁵⁷¹ "Employment" includes any service, of whatever nature, performed by an employee for his employer, irrespective of the citizenship or residence of either, within the U.S.⁵⁷²

2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.

a. Wages Paid by U.S. Person/Employer. A U.S. person/employer must generally pay FUTA taxes on wages paid to a nonresident alien employee for work performed within the U.S.⁵⁷³

b. Wages Paid by Foreign Person/Employer. A foreign person/employer must generally pay FUTA taxes on wages paid to a nonresident alien employee for work performed within the U.S.⁵⁷⁴

3. Exceptions to Liability for Persons in Certain Visa Categories. Exceptions to the general liability rules apply to persons in the U.S. under certain visa categories. Notably, services performed by a nonresident alien individual who is temporarily present in the U.S. under F, J, M or Q visa status are exempted from the FUTA requirement if the services are performed to carry out the purpose for which the individual was admitted to the U.S.⁵⁷⁵

C. Self-Employment Tax. Self-employment income derived by a nonresident alien individual is not subject to the self-employment tax (SECA).⁵⁷⁶

⁵⁶⁹See I.R.C. § 3306(b).

⁵⁷⁰See I.R.C. § 162(a); *Eastman Kodak Co. v. U.S.*, 534 F.2d 252 (Ct. Cl. 1976); Rev. Rul. 96-51, 1996-2 C.B. 36, modified by Rev. Rul. 2007-12, 2007-1 C.B. 685; Rev. Rul. 86-14, 1986-1 CB 304.

⁵⁷¹I.R.C. § 3306(b).

⁵⁷²I.R.C. § 3306(c).

⁵⁷³Rev. Rul. 92-106, 1992-2 C.B. at 260.

⁵⁷⁴*Ibid.*

⁵⁷⁵I.R.C. § 3306(c)(19).

⁵⁷⁶I.R.C. § 1402(b); Treas. Reg. § 1.1402(b)-1(d).

CHAPTER XIII: TAX TREATIES

A. Functions of Tax Treaties. In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. Tax treaties generally have three main functions:

1. Avoiding the double taxation of income, property or property transfers, by allocating or limiting the right of the source or the residence country to tax income or property;
2. Avoiding discriminatory tax treatment of residents of the Contracting States; and
3. Permitting reciprocal administrative assistance in the prevention of tax avoidance and tax evasion.

B. Persons Covered. The persons generally covered by a tax treaty are the residents or entities of the treaty countries.

C. Issues Covered. Income tax treaties often cover the following issues:

1. The trade or business of a nonresident is not taxable unless such trade or business is conducted through or effectively connected with a permanent establishment.
2. Passive income is generally taxed at a reduced rate or, in certain cases, such income may be totally exempt.
3. Income derived from the performance of personal services is generally more favorably treated. For instance, certain treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings of over a certain amount).⁵⁷⁷
4. The branch tax rate may be reduced or eliminated altogether.
5. Double taxation is avoided through the allowance of foreign tax credits, foreign country exemptions or reduced rates of tax, and competent authority provisions.

D. Other Matters Often Covered in Income Tax Treaties. Other matters often covered in an income tax treaty include:

⁵⁷⁷Staff of Joint Comm. on Taxation, 103rd Cong., 1st Sess., *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and Mexico*, at 37 [hereinafter “Joint Committee Treaty Report”].

1. Eliminating double taxation by defining the term “resident” so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries.⁵⁷⁸

2. Providing for exemption of income from shipping and air transport operations.

3. Addressing the tax treatment of visiting artists and athletes.

4. Providing special source rules.

5. Providing that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that which it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.⁵⁷⁹

6. Providing for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws.⁵⁸⁰

7. Prohibiting treaty shopping by limiting treaty benefits to bonafide residents of the two countries.⁵⁸¹

E. Disclosure Requirement. Taxpayers who take the position that a U.S. treaty overrides or otherwise modifies an Internal Revenue law and thereby effects a tax reduction are required to disclose the position on statements attached to their returns.⁵⁸² This requirement applies to positions based upon any U.S. treaty, including an income tax treaty, an estate and gift tax treaty, and a friendship, commerce and navigation treaty.⁵⁸³ Taxpayers who are not otherwise required to file a U.S. tax return must, nevertheless, file a return to make the required disclosure under Section 6114.⁵⁸⁴ If reporting is required under Section 6114, Treasury Regulation Section 301.6114-1(d) lists the information required to be provided as an attachment to the return. The IRS has developed Form 8833 for use by taxpayers to make the treaty-based return position disclosure required by Section 6114.⁵⁸⁵ A taxpayer who fails in a material way to disclose one or more treaty-based return positions as required by Section 6114, is subject to a separate penalty for each failure in the amount of \$1,000 (\$10,000 in the case of a C

⁵⁷⁸Joint Committee Treaty Report at 36-37.

⁵⁷⁹Joint Committee Treaty Report at 38.

⁵⁸⁰Joint Committee Treaty Report at 37.

⁵⁸¹Joint Committee Treaty Report at 38.

⁵⁸²I.R.C. § 6114.

⁵⁸³Treas. Reg. § 301.6114-1(a)(1)(i).

⁵⁸⁴Treas. Reg. § 301.6114-1(a)(ii).

⁵⁸⁵Ann. 93-63, 1993-16 I.R.B. 11.

corporation).⁵⁸⁶ The penalty may be waived by the I.R.S. if the taxpayer's failure to disclose was not due to willful neglect.⁵⁸⁷

F. Relationship of Treaties to Internal U.S. Law.

1. How are Treaties Adopted? In the U.S., the procedure involved in adopting a treaty is different from that involved in passing a Federal statute. Treaties must be negotiated between the Executive branch and a foreign government, consented to by two-thirds vote of the Senate, and ratified by the President.⁵⁸⁸ Federal statutes, on the other hand, must be passed by both Houses of Congress and signed by the President, or passed over the President's veto by two-thirds vote of both Houses.⁵⁸⁹

2. U.S. Constitution. Article 6, clause 2 of the U.S. Constitution provides that the "Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land"

3. Provisions of Internal Revenue Code Affecting Interrelationship between Treaties and Internal U.S. Law. Under Section 894(a) of the Code, the provisions of the Code are required to be applied to any taxpayer with "due regard" to any treaty obligation of the U.S. which applies to the taxpayer. Section 7852(d)(1) of the Code provides that, for purposes of determining the relationship between a provision of a treaty and any tax law of the U.S., "neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." Congress added the quoted language to 7852(d) in 1988 to clarify that Section 7852(d) does not prevent application of the general rule providing that the later in time of a statute or treaty controls.⁵⁹⁰

G. Authority of the Commissioner to Recharacterize Transactions Involving Treaty Shopping.

1. I.R.C. § 7701(l). On August 10, 1993, Congress enacted section 7701(l) of the Internal Revenue Code (the "Code"), which authorizes Treasury to "prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where [Treasury] determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title." Pursuant to this authority, Treasury issued final regulations, effective September 11, 1995, permitting "the district director to disregard, for purposes of sections 871, 881, 1441 and 1442, the participation of one or more persons in a conduit financing arrangement."⁵⁹¹

⁵⁸⁶I.R.C. § 6712; Treas. Reg. § 301.6712-1(a).

⁵⁸⁷I.R.C. § 6712; Treas. Reg. § 301.6712-1(b).

⁵⁸⁸U.S. Const., art. 2, § 2(2).

⁵⁸⁹U.S. Const., art. 1, § 7(2); Staff of the Joint Comm. on Taxation, 101st Cong., 2d Sess., *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90) (1990).

⁵⁹⁰Staff of the Joint Comm. On Taxation, 100th Cong., 2d Sess., *Description of the Technical Corrections Act of 1988* (H.R. 4333 and S. 2238) (JCS-10-88) (1988).

⁵⁹¹T.D. 8611, 1995-37 I.R.B. 20, 21, corrected by 1995-2 C.B. 286 and corrected by 1998 W.L. 840741.

The final regulations under Section 7701(l) provide rules that permit the IRS district director to disregard the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities.⁵⁹² Although the regulations were issued under Section 881, “any reference to tax imposed under section 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under section 871 or 884(f)(1)(A) or required to be withheld under section 1441 or 1442.”⁵⁹³

Under the regulations, “financing arrangement” generally means a series of transactions by which:

a. One person (the “financing entity”) advances money or other property, or grants rights to use property;

b. Another person (the “financed entity”) receives money or other property, or rights to use property;

c. The advance and receipt are effected through one or more other persons (the “intermediate entities”); and

d. There are financing transactions (e.g., debt)⁵⁹⁴ linking the financing entity, each of the intermediate entities, and the financed entity.⁵⁹⁵

If the IRS disregards a conduit entity in a financing arrangement, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (in most cases, the financed entity and the financing entity).⁵⁹⁶

An intermediate entity will be a conduit entity only if:

The participation of the intermediate entity in the financing arrangement reduces the U.S. withholding tax that otherwise would have been imposed,⁵⁹⁷ and

e. The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and

f. Either:

(1) The intermediate entity is related to the financing entity or the financed entity; or

⁵⁹²Treas. Reg. § 1.881-3(a)(1).

⁵⁹³Treas. Reg. § 1.881-3(a)(1).

⁵⁹⁴Treas. Reg. § 1.881-3(a)(2)(ii).

⁵⁹⁵Treas. Reg. § 1.881-3(a)(2)(i)(A).

⁵⁹⁶Treas. Reg. § 1.881-3(a)(3)(ii)(A).

⁵⁹⁷See Treas. Reg. § 1.881-3(e), Examples 9 & 10 (no conduit entity if no reduction in U.S. withholding tax).

(2) The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.⁵⁹⁸

2. Judicial Doctrines. The IRS may also attack a treaty structure using judicially-developed doctrines. The courts have stated that the incidence of taxation depends upon the substance of a transaction as a whole.⁵⁹⁹ In certain treaty-related cases, the courts have recharacterized transactions in order to impose tax consistent with this principle. For example, where three parties have engaged in a chain of transactions, the courts have at times ignored the “middle” party as a mere “conduit,” and imposed tax as if a single transaction had been carried out between the parties at the ends of the chain.⁶⁰⁰

In *Aiken Industries, Inc. v. Commissioner*,⁶⁰¹ the Tax Court recharacterized an interest payment by a U.S. person on its note held by a related treaty-country resident, which in turn had a precisely matching obligation to a related non-treaty country resident, as a payment directly by the U.S. person to the non-treaty country resident. The transaction in its recharacterized form resulted in a loss of the treaty protection that would otherwise have applied on the payment of interest by the U.S. person to the treaty-country resident, and thus caused the interest payment to give rise to 30-percent U.S. tax.

In *Northern Indiana Public Service Company v. Commissioner*,⁶⁰² the Seventh Circuit Court of Appeals “glean[ed]” the following from *Aiken Industries* and similar cases: “Transactions involving a foreign corporation are to be disregarded for lack of meaningful economic activity if the corporation is merely transitory, engaging in absolutely no business activity for profit -- in other words, it is a ‘mere skeleton’ . . . Transactions will also be disregarded if the foreign corporation lacks dominion and control over the interest payments it collects.”

3. Limitation of Benefits Provisions in Income Tax Treaties. The benefits available under an applicable income tax treaty may be limited by a Limitation on Benefits provision in the treaty itself. “The United States views an income tax treaty as a vehicle for providing treaty benefits to residents of the two Contracting States. This statement begs the question of who is to be treated as a resident of a Contracting State for the purpose of being granted treaty benefits . . . The United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries. Consequently, all recent U.S. income tax treaties contain comprehensive Limitation on Benefits provisions.”⁶⁰³

⁵⁹⁸Treas. Reg. § 1.881-3(a)(4)(i).

⁵⁹⁹*See, e.g., Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

⁶⁰⁰*See, e.g., Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925, *acq. on another issue*, 1972-2 C.B. 1; *see also* H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess., 655 (1993), 1993-3 C.B. 657.

⁶⁰¹56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B. 1.

⁶⁰²115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995).

⁶⁰³U.S. Treas. Dep’t, “Technical Explanation of the United States Model Income Tax Convention of September 20, 1996,” at p. 88.

A Limitation of Benefits provision “assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State who have a substantial presence in, or business nexus with, that State. Absent this Article, if a resident of a third State were to organize a corporation in a contracting State for the purpose of deriving treaty-benefited income from the other Contracting State, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to any limitations imposed by the domestic law of the source State (e.g., business purpose, substance-over-form, step transaction or conduit principles).”⁶⁰⁴

⁶⁰⁴U.S. Treas. Dep’t, Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on September 18, 1992, 1994-2 C.B. 489.

CHAPTER XIV: U.S. ESTATE AND GIFT TAX CONSIDERATIONS FOR NONRESIDENT ALIENS

A. General Rule Applicable to Nonresident Aliens for Purposes of U.S. Federal Estate and Gift Taxation. For U.S. federal estate and gift tax purposes, nonresident aliens are subject to U.S. federal estate and gift tax on their “property situated in the U.S.”⁶⁰⁵

B. Residency for U.S. Estate and Gift Tax Purposes. The residency test for federal estate and gift tax purposes is different than the residency test for federal income tax purposes. For U.S. estate and gift tax purposes, a U.S. resident is an individual who was domiciled in the U.S. at the time of his death or gift, whichever is applicable.⁶⁰⁶ A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving. Residence without the requisite present intention to remain indefinitely will not sufficiently constitute a domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.⁶⁰⁷ An individual may be a “resident” for income tax purposes but not for estate and gift tax purposes. Also, U.S. estate tax treaties may affect the determination of whether an alien is domiciled in the U.S. for U.S. estate tax purposes.

C. Overview of U.S. Estate Tax Rules Applicable to Nonresident Aliens.

1. Determining the Gross Estate. For U.S. estate tax purposes, the gross estate of a nonresident alien consists of all U.S. situs property in which the alien decedent had an interest at the time of his death.⁶⁰⁸

a. Property Situated in the U.S. Property situated in the U.S. includes (but is not limited to) the following:

- (1)** U.S. real estate;⁶⁰⁹
- (2)** Tangible personal property located in the U.S.;⁶¹⁰
- (3)** Stock in a U.S. corporation;⁶¹¹ and
- (4)** Certain debt obligations of a U.S. person.⁶¹²

⁶⁰⁵I.R.C. §§ 2101(a), 2103, 2501(a)(1), 2511.

⁶⁰⁶Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-1(b).

⁶⁰⁷Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-1(b)..

⁶⁰⁸I.R.C. § 2103.

⁶⁰⁹Treas. Reg. § 20.2104-1(a)(1).

⁶¹⁰Treas. Reg. § 20.2104-1(a)(2).

⁶¹¹I.R.C. § 2104(a); Treas. Reg. § 20.2104-1(a)(5).

⁶¹²I.R.C. § 2104(c).

The treatment of a partnership interest in a U.S. partnership is unclear. Existing authority suggests that an interest in a U.S. partnership carrying on business in the U.S. with U.S.-situs assets should be includable in the gross estate of a nonresident alien.⁶¹³

b. Property Not Situated in the U.S. Property that is not situated in the U.S. includes (but is not limited to) the following:

- (1) Foreign real estate;⁶¹⁴
- (2) Tangible personal property located outside the U.S.;⁶¹⁵
- (3) Proceeds of life insurance on the life of a nonresident alien;⁶¹⁶
- (4) Deposits, including certificates of deposit, in U.S. banks and U.S. savings institutions unless the interest earned on such deposits is effectively connected with the conduct of a U.S. trade or business in the U.S., or unless the nonresident alien is considered a U.S. resident for income tax purposes;⁶¹⁷
- (5) Stock issued by a foreign corporation;⁶¹⁸
- (6) A debt instrument issued by a U.S. person if the interest generated by such instrument constitutes “portfolio interest” (except for certain contingent portfolio interest);⁶¹⁹ and
- (7) Short-term original issue debt obligations, if any interest thereon (were such interest received by the decedent at the time of his death) would not be effectively connected with the conduct of a U.S. trade or business.⁶²⁰

2. Estate Tax Rates. The estate tax rates applicable to U.S. citizens and residents are also applicable to taxable estates of nonresident aliens.⁶²¹

3. Estate Tax Credit. A nonresident alien’s estate is allowed a unified credit of \$13,000.⁶²²

⁶¹³See Rev. Rul. 55-701, 1955-2 C.B. 836; *see generally* 2 RUFUS RHOADES & MARSHALL J. LANGER, U.S. INTERNATIONAL TAXATION AND TAX TREATIES, §33.02[2][a][vi] (2010) (analyzing whether partnership interest is includable in the U.S. gross estate); Martin, “Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (And Are Not) Subject to United States Estate Tax,” 2003 TNT 94-127 (May 13, 2003).

⁶¹⁴Treas. Reg. § 20.2105-1(a)(1).

⁶¹⁵Treas. Reg. § 20.2105-1(a)(2).

⁶¹⁶I.R.C. § 2105(a).

⁶¹⁷I.R.C. §§ 2105(b), 871(i)(3).

⁶¹⁸Treas. Reg. § 20.2105-1(f).

⁶¹⁹I.R.C. § 2105(b)(3).

⁶²⁰I.R.C. § 2105(b)(4).

⁶²¹I.R.C. § 2101.

D. Overview of U.S. Gift Tax Rules Applicable to Nonresident Aliens. A U.S. imposes a tax on taxable gifts by any individual, resident or nonresident, but in the case of nonresident aliens, the statute applies only to taxable gifts of property situated in the U.S.⁶²³ An exception applies for certain transfers of intangible property.⁶²⁴

E. U.S. Estate and Gift Tax Treaties. There are also a number of estate and gift tax treaties that reduce or eliminate the otherwise applicable U.S. estate or gift tax. These treaties provide uniform rules on residency, location of property, and exemptions from home country tax with respect to certain types of property.

⁶²²I.R.C. § 2102(c)(1).

⁶²³I.R.C. § 2501(a)(1); *see* I.R.C. § 2511.

⁶²⁴*See* I.R.C. 2501(a)(2).

CHAPTER XV: THIN CAPITALIZATION ISSUES

A. Advances Between Related Companies Are Closely Scrutinized. Advances between a parent corporation and a subsidiary or other affiliate are closely scrutinized by the Service and the courts “because the control element suggests the opportunity to contrive a fictional debt.”⁶²⁵ Although the existence of a bona fide debt is not precluded merely because the debtor and creditor are related parties,⁶²⁶ the courts recognize that the form of “the transaction and the labels parties place on the transaction may not have as much significance when the corporation is closely held because the parties can mold the transaction at their will.”⁶²⁷

B. Judicial Analysis of Debt-Equity Cases. No single uniform approach has been adopted by the courts in analyzing whether particular advances constitute debt or equity, and the results of each case usually depend upon the individual facts and circumstances involved.⁶²⁸ The courts have enumerated several factors to be considered in resolving a debt-equity issue. The courts decide how much weight to give to each of these factors based on the facts and circumstances of each case.⁶²⁹ The identified factors are neither equally significant nor is any single factor determinative or relevant in each case.⁶³⁰ The Tax Court has stated that the determinative question, to which an evaluation of the various independent factors should ultimately point, is whether there was a “genuine intention to create a debt, with a reasonable expectation of repayment, and . . . [whether] that intention comport[s] with the economic reality of creating a debtor-creditor relationship.”⁶³¹

The U.S. Court of Appeals for the Fifth Circuit has identified 13 nonexclusive factors to be considered in deciding whether advances are debt or equity.⁶³² Those factors are:

1. The name given to the certificate evidencing the advance. The name given to the certificates evidencing the advances suggests whether advances are debt or equity.⁶³³

2. The presence or absence of a fixed maturity date. The presence of a fixed maturity date can indicate that an advance is debt.⁶³⁴ The absence of a fixed maturity date

⁶²⁵See *Matter of Uneco, Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cayuna Realty Co. v. United States*, 382 F.2d 298, 300-01 (Ct. Cl. 1967)); *P.M. Fin. Corp. v. Commissioner*, 302 F.2d 786, 789 (3d Cir. 1962); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Calumet Indus. Inc. v. Commissioner*, 95 T.C. 257, 286 (1990); *Malone & Hyde, Inc. v. Commissioner*, 49 T.C. 575, 578 (1968).

⁶²⁶*Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), *rev'g*, 21 T.C. 513 (1954), *acqu.*, 1968-2 C.B.1.

⁶²⁷*Calumet Indus. Inc. v. Commissioner*, 95 T.C. 257, 286 (1990).

⁶²⁸*Litton Business Systems v. Commissioner*, 61 T.C. 367, 376 (1973), *acqu.* 1974-2 C.B.1.

⁶²⁹*Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *see John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946).

⁶³⁰*Estate of Mixon v. United States*, 464 F.2d at 402 (5th Cir. 1972); *Calumet*, 95 T.C. at 285.

⁶³¹*Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. (CCH) 682, 700 (1995), (quoting *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973)), *vacated and remanded on another issue*, 152 F.3d 83 (2d Cir. 1998).

⁶³²*Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972). The Ninth Circuit has identified eleven factors. *See Hardman v. U.S.*, 827 F.2d 1409, 1412 (9th Cir. 1987); *Bauer v. Comm'r*, 748 F.2d 1365 (9th Cir. 1984); *cf. F.S.A. 199922012* (June 4, 1999).

⁶³³*Estate of Mixon v. United States*, 464 F.2d at 402-403.

⁶³⁴*Id.* at 404.

indicates that “repayment was in some way tied to the fortunes of the business, indicative of an equity advance.”⁶³⁵ The right to enforce maturity dates may be meaningless, however, if the parties do not expect the recipient to repay.⁶³⁶ Postponing maturity dates for prolonged periods suggests that the nominal lender does not intend to require repayment and that the transfers are equity.⁶³⁷ A reasonable expectation of repayment by the provider of an advance when the advance is made suggests that the advance is debt.⁶³⁸

3. The source of repayments of advances (i.e., whether the recipient of the funds can repay the advance with reasonably anticipated cash-flow or liquid assets). An advance is more likely to be equity if the recipient does not have liquid assets or reasonably anticipated cash-flow from which to repay.⁶³⁹

4. Whether the provider of the funds has the right to enforce payment of principal and interest. A definite obligation to repay an advance suggests that the advance is a loan.⁶⁴⁰

5. Whether the provider of the advance gains an increased right to participate in management. If, as a result of an advance of funds, the provider of the funds has an increased right to participate in the management of the recipient, then it is acting more like a shareholder than a creditor.⁶⁴¹

6. The status of the contribution in relation to regular creditors. Whether an advance is equal or subordinate to the claims of regular corporate creditors affects whether the taxpayer was dealing as a shareholder or creditor.⁶⁴² Failure to demand timely repayment effectively subordinates intercompany debt to the rights of other creditors who receive payment in the interim.⁶⁴³

⁶³⁵*Estate of Mixon*, 464 F.2d at 404.

⁶³⁶*Foresun, Inc. v. Commissioner*, 41 T.C. 706, 717 (1964), *aff'd in part, modified in part and remanded* 348 F.2d 1006, 1009 (6th Cir. 1965); *see Slappey Drive Indus. Park v. United States*, 561 F.2d 572, 583 n.18 (5th Cir. 1977); *Harlan v. United States*, 409 F.2d 904, 907 n.4 (5th Cir. 1969).

⁶³⁷*Slappey Drive Indus. Park v. United States*, 561 F.2d at 583; *Harlan v. United States*, 409 F.2d at 909; *Foresun, Inc. v. Commissioner*, 41 T.C. at 706, *aff'd as to this issue*, 348 F.2d at 1009.

⁶³⁸*Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957), *remanding* 15 T.C.M. (CCH) 688 (694); *C.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649, 656 (1968); *Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. (CCH) 682 (1995), *vacated and remanded on another issue*, 152 F.3d 83 (1998).

⁶³⁹*Estate of Mixon v. United States*, 464 F.2d at 405; *Segel v. Commissioner*, 89 T.C. 816, 830-831 (1987); *Laidlaw Transportation, Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598, 2622 (1998).

⁶⁴⁰*Estate of Mixon v. United States*, 464 F.2d at 405; *see Campbell v. Carter Found. Prod. Co.*, 322 F.2d 827, 832 (5th Cir. 1963).

⁶⁴¹*Estate of Mixon v. United States*, 464 F.2d at 406; *American Offshore, Inc. v. Commissioner*, 97 T.C. 579, 603 (1991).

⁶⁴²*Estate of Mixon v. United States*, 464 F.2d at 406; *American Offshore, Inc. v. Commissioner*, 97 T.C. at 603.

⁶⁴³*American Offshore, Inc.*, 97 T.C. at 603; *Inductotherm Indus., Inc. v. Commissioner*, 48 T.C.M. (CCH) 167 (1984), *aff'd without published opinion* 770 F.2d 1071 (3rd Cir. 1985).

7. Intent of the parties. The intent of the parties is important in deciding whether payments are debt or equity.⁶⁴⁴ More weight, however, is given to objective facts than to stated intent.⁶⁴⁵

8. Whether the recipient of the advance is adequately capitalized. Courts generally consider a borrower's debt-to-equity ratio and other financial data in deciding if it is thinly capitalized. Inadequate capitalization strongly suggests that an advance is equity if: (a) the debt to equity ratio was initially high, (b) the parties realized that it would likely go higher, and (c) the recipient of the funds used a substantial part of the funds to buy capital assets and to meet expenses needed to begin operations.⁶⁴⁶

9. Identity of interest between the creditor and the shareholder. If advances by shareholder are proportionate to their stock ownership, the advances are more likely to be equity.⁶⁴⁷ On the other hand, a sharply disproportionate ratio between a stockholder's percentage stock holdings and debt is strongly indicative that the debt is bona fide.⁶⁴⁸

10. Source of interest payments (i.e., whether the recipient of the funds pays interest from earnings). Payment of interest by the recipient of an advance suggests that a transfer is debt.⁶⁴⁹ The failure to insist on interest payments indicates that the payors are not expecting substantial interest income, but are more interested in the future earnings of the corporation or the increased market value of their interest.⁶⁵⁰

11. The ability of the corporation to obtain loans from outside lending institutions. If a corporation can borrow money from outside sources when it receives a transfer of funds, the transfer is more likely to be debt.⁶⁵¹

12. The extent to which the recipient used the advance to buy capital assets. A corporation's use of cash advances to acquire capital assets suggests that an advance is equity.⁶⁵² Use of an advance by an ongoing business to expand its operations, for example, by acquiring an existing business, suggests that the advance is equity.⁶⁵³

⁶⁴⁴*Estate of Mixon v. United States*, 464 F.2d at 407.

⁶⁴⁵*In re Lane*, 742 F.2d 1311 (11th Cir. 1984); *Estate of Mixon v. United States*, 464 F.2d at 397.

⁶⁴⁶*Estate of Mixon v. United States*, 464 F.2d at 408; *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969); *United States v. Henderson*, 375 F.2d 36, 40 (5th Cir. 1967); *American Offshore, Inc. v. Commissioner*, 97 T.C. 579, 604 (1991).

⁶⁴⁷*Slappey Drive Indus. Park*, 561 F.2d at 583; *Estate of Mixon v. United States*, 464 F.2d at 409; *Tyler v. Tomlinson*, 414 F.2d at 850; *Tomlinson v. 1661 Corp.*, 377 F.2d 291, 297 (5th Cir. 1967); *American Offshore, Inc. v. Commissioner*, 97 T.C. at 604; *Leach Corp. v. Commissioner*, 30 T.C. 563, 579 (1958), acq. 1959-2 C.B. 3.

⁶⁴⁸*American Offshore, Inc. v. Commissioner*, 97 T.C. at 604.

⁶⁴⁹*Estate of Mixon v. United States*, 464 F.2d at 409; *American Offshore, Inc. v. Commissioner*, 97 T.C. 605.

⁶⁵⁰*American Offshore Inc. v. Commissioner*, 97 T.C. at 605.

⁶⁵¹*Estate of Mixon v. United States*, 464 F.2d at 410; *Tomlinson v. 1661 Corp.*, 377 F.2d at 299; *American Offshore, Inc. v. Commissioner*, 97 T.C. at 605.

⁶⁵²*Slappey Drive Indus. Park v. United States*, 561 F.2d at 583; *Estate of Mixon v. United States*, 464 F.2d at 410.

⁶⁵³*Plantation Patterns, Inc. v. United States*, 462 F.2d 712, 722 (5th Cir. 1972); *Tyler v. Tomlinson*, 414 F.2d at 848-849.

13. Whether the recipient repaid the funds on the due date. The failure of a corporation to repay principal amounts on the due date indicates that advances were equity.⁶⁵⁴

C. Laidlaw Transportation, Inc. v. Commissioner. In *Laidlaw Transportation, Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598 (1998), Laidlaw Transportation, Ltd., a Canadian corporation, owned all of the stock of Laidlaw Transportation Inc. (“LTI”).⁶⁵⁵ LTI and its U.S. subsidiaries received nearly a billion dollars from 1984 to 1988 from a related Dutch corporation (“LIIBV”).⁶⁵⁶ During the same period, LTI transferred \$133 million in interest payments to LIIBV.⁶⁵⁷ The Commissioner challenged the substance of the advances to LTI arguing that the advances constituted equity.⁶⁵⁸ The Tax Court determined that the advances were equity and disallowed an interest deduction.⁶⁵⁹ The Tax Court determined that the transactions at issue were not at arm’s length as evidenced by the existence of a common chair, directors, officers and core management team, and the fact that there were related entities with interlocking directorates.⁶⁶⁰

Factors weighing in favor of debt included: (1) characterization of the advances as debt.⁶⁶¹ Factors weighing in favor of equity included (1) the Dutch lender did not intend to enforce the loan maturity dates;⁶⁶² (2) the taxpayers’ liquid assets and reasonably anticipated cash flow were insufficient to pay the interest or the principal balance on the loans from LIIBV;⁶⁶³ (3) although LIIBV had a right to enforce payment of principal and interest, LIIBV and the taxpayers’ did not enforce any of the loan agreements;⁶⁶⁴ (4) LIIBV’s postponement of repayments from the taxpayers effectively subordinated the purported debt to LIIBV and this effective subordination made the obligations to repay LIIBV inferior to the claims of the taxpayers’ regular corporate creditors;⁶⁶⁵ (5) LIIBV and the taxpayers did not intend the advances to be treated as loans because LIIBV made large advances, extended the terms for payment, did not seek security in the written agreements, and represented to Canadian tax officials that the loans are “in the nature of capital contributions;”⁶⁶⁶ (6) the taxpayers’ were

⁶⁵⁴*Estate of Mixon v. United States*, 464 F.2d at 410; see *Slappey Drive Indus. Park v. United States*, 561 F.2d at 582; see also *Texas Farm Bureau v. United States*, 725 F.2d 307, 311 (5th Cir. 1984); *Plantation Patterns Inc. v. Commissioner*, 462 F.2d 712, 718-719 (5th Cir. 1972), *aff’g*. 29 T.C. M. (CCH) 817 (1970); *Tyler v. Tomlinson*, 414 F.2d at 848-850; *Berkowitz v. United States*, 411 F.2d 818, 821 (5th Cir. 1969); *American Offshore, Inc. v. Commissioner*, 97 T.C. 606; *Laidlaw Transportation Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598, 2623; *Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. at 700; *Lansall Company v. United States*, 512 F.Supp. 1178, 1180 (S.D.N.Y. 1981).

⁶⁵⁵*Laidlaw Transportation, Inc. v. Commissioner*, 75 T.C.M. (CCH) at 2599-2600.

⁶⁵⁶*Id.* at 2598.

⁶⁵⁷*Ibid.*

⁶⁵⁸*Id.* at 2599.

⁶⁵⁹*Id.* at 2624.

⁶⁶⁰*Id.* at 2616.

⁶⁶¹*Id.* at 2617.

⁶⁶²*Id.* at 2617-2618.

⁶⁶³*Id.* at 2618.

⁶⁶⁴*Id.* at 2619.

⁶⁶⁵*Laidlaw Transportation, Inc. v. Commissioner*, 75 T.C.M. (CCH) at 2619-2620.

⁶⁶⁶*Id.* at 2620.

thinly capitalized;⁶⁶⁷ (7) the taxpayers postponed interest payments, used debt to finance interest payments, and continued to increase their indebtedness;⁶⁶⁸ (8) the taxpayers could not have borrowed nearly a billion dollars on the same terms as those made by LIIBV;⁶⁶⁹ (9) the taxpayers used most of the advances from LIIBV to expand their operations, especially by acquiring other companies, and told the Canadian tax authorities that advances through LIIBV were capital investments which formed a part of the subsidiaries' permanent capital;⁶⁷⁰ (10) LIIBV repeatedly deferred and extended the vast majority of principal payments;⁶⁷¹ (11) LIIBV's directors did not expect to be repaid or intend to request repayment.⁶⁷²

Factors that were neutral were (1) the documents evidencing the advances did not give LIIBV any right to participate in the management of the borrowers or the guarantors, but this would have been unnecessary because LTL and its core management team already controlled LIIBV;⁶⁷³ (2) the fact that LIIBV did not directly own any stock in the taxpayers;⁶⁷⁴ (3) the fact that LIIBV transferred cash to the taxpayers in exchange for debt;⁶⁷⁵ and (4) the taxpayers had not stated right to convert the creditor's loans to stock.⁶⁷⁶

The Court determined that the factors that relate to the form of the transaction support treating the LIIBV advances to the taxpayers as debt. The factors relating to substance support treating the LIIBV advances as equity. The Court stated that the substance of the transactions is revealed in the lack of arm's length dealing between LIIBV and the taxpayers, the circular flow of funds, and the conduct of the parties by changing the terms of the agreements when needed to avoid deadlines.⁶⁷⁷

In holding for the Commissioner, the Tax Court noted that the advances were structured in a manner that ultimately created a "double deduction" to the Canadian parent on a global basis.⁶⁷⁸ The Canadian parent borrowed funds from an independent lender and transferred these funds, as capital contributions, to a wholly-owned Netherlands subsidiary. The Netherlands subsidiary in turn loaned those funds, with stated interest, to U.S. sister companies that were also wholly-owned by the Canadian parent. Under this structure, the Canadian parent deducted interest on its loan with the outside lender, and the U.S. subsidiaries deducted interest on its borrowings from the Netherlands subsidiary.⁶⁷⁹

⁶⁶⁷*Id.* at 2620-2621.

⁶⁶⁸*Id.* at 2622.

⁶⁶⁹*Id.* at 2623.

⁶⁷⁰*Ibid.*

⁶⁷¹*Ibid.*

⁶⁷²*Id.* at 2624.

⁶⁷³*Id.* at 2619.

⁶⁷⁴*Id.* at 2621-2622.

⁶⁷⁵*Id.* at 2624.

⁶⁷⁶*Ibid.*

⁶⁷⁷*Ibid.*

⁶⁷⁸*Id.* at 2602.

⁶⁷⁹*Ibid.*

D. Nestle Holdings, Inc. v. Commissioner. In *Nestle Holdings, Inc. v. Commissioner*,⁶⁸⁰ Nestle Holdings, Inc. (“Nestle”) was a first-tier subsidiary of Nestle S.A. (“NSA”), a publicly-held corporation headquartered in Switzerland.⁶⁸¹ The dispute arose from a tender offer by Nestle for the stock of Carnation Company.⁶⁸² Nestle’s initial plan was to finance its acquisition of Carnation with a capital contribution of \$ 525 million from NSA and a \$2.5 billion loan from outside sources.⁶⁸³ Ultimately, this plan was revised, and the acquisition was financed in 1985 by commercial loans of \$1.6 billion and related-party loans of \$1.325 billion.⁶⁸⁴ NSA provided some of these related-party loans but made no capital contributions to Nestle. The tender offer succeeded and, in January 1985, Carnation became a consolidated subsidiary of Nestle.⁶⁸⁵ After the acquisition, Nestle made requisite interest and principal payments to the related parties and deducted the interest payments as expenses on its tax returns.⁶⁸⁶

The Service disallowed the interest deduction claimed by Nestle contending that NSA intended to make a capital contribution to Nestle but characterized its investment as debt so as to obtain tax benefits.⁶⁸⁷ The Tax Court rejected the Service’s arguments and held that the advances constituted debt.⁶⁸⁸

The Tax Court found that NSA and Nestle had a genuine intention that the advances create a debt obligation. The revised financing structure that did not include a capital contribution was the result of additional time for planning and was supported by valid business reasons. The Court also found substantial objective evidence of an intent to create a debtor-creditor relationship and evidence negating a capital contribution intent. Because of the anticipated fall of the dollar against the Swiss franc and the hedging policy of NSA, NSA had business reasons for not making an equity investment in Nestle.⁶⁸⁹

The Court also found that Nestle anticipated that the combined Nestle-Carnation entities would have a high level of cash and investments on hand that could be used to pay down debt; that divestiture of assets would be used to pay debt; and also the cash flow from the combined entities would be adequate for debt service. The advances in this case contained interest and payment provisions, and timely principal and interest payments were made. Moreover, the advances were made as part of an acquisition of a complete, existing enterprise that had valuable assets and an established market position.⁶⁹⁰

⁶⁸⁰70 T.C.M. (CCH) 682 (1995), *vacated and remanded on another issue*, 152 F.3d 83 (2d Cir. 1998).

⁶⁸¹*Id.* at 685.

⁶⁸²*Id.* at 688.

⁶⁸³*Id.* at 689.

⁶⁸⁴*Id.* at 689-690.

⁶⁸⁵*Id.* at 688.

⁶⁸⁶*Id.* at 693-94.

⁶⁸⁷*Id.* at 700.

⁶⁸⁸*Id.* at 705.

⁶⁸⁹*Id.* at 701.

⁶⁹⁰*Ibid.*

The Court also determined that Nestle, as a separate entity, could have obtained the full amount from some combination of private lenders and commercial banking sources. The Court held that the terms of the related-party advances cannot be characterized as a patent distortion of what would normally have been available to a taxpayer as independent-debt financing.⁶⁹¹

The Court also relied heavily on Nestle making a net reduction of related party debt beginning in 1985 in addition to making timely interest payment.⁶⁹² The Court also found that there was no evidence that the Nestle's debt/equity or leverage ratios were out of line with other companies.

E. Plantation Patterns Doctrine.

1. What is the Plantation Patterns Doctrine? The *Plantation Patterns* doctrine is a judicially-developed doctrine that treats a guarantor as the true obligor for U.S. federal income tax purposes.⁶⁹³ Thus, in cases where a subsidiary's debt is guaranteed by a parent corporation, the U.S. Internal Revenue Service may (in an examination) review the loan arrangement to determine whether the loan of the third-party creditor represents, in substance, a primary debt obligation of the parent corporation guarantor instead of a primary debt obligation of the subsidiary. In such a case, the loan to the debtor is deemed under the *Plantation Patterns* doctrine to be a loan made directly to the guarantor that is, in turn, contributed by the guarantor as equity to the nominal debtor. Payments by the subsidiary corporation on the guaranteed obligation are treated for federal income tax purposes as dividends to the guarantor/parent, and the guarantor/parent in turn is treated as having made the interest payments on its obligation to the creditor.⁶⁹⁴

2. When Do The Courts Generally Apply the Plantation Patterns Doctrine? The *Plantation Patterns* doctrine arose from a case in which a newly-formed corporation with nominal capitalization ("Newco") purchased all the stock of another corporation ("Oldco"). Newco paid for the Oldco stock by making a small down payment and issuing promissory notes for the balance. The notes were guaranteed by Newco's individual shareholder. The guarantees were necessary because of the low down payment and because the debt had to be unsecured to enable the new corporation to obtain financing for its operations.

In reviewing the notes issued by Newco, the Revenue Service concluded that the notes were in substance indirect capital contributions by the shareholder to the corporation. The Revenue Service disallowed interest deductions claimed by the thinly-capitalized Newco corporation and treated interest payments as nondeductible dividends to the shareholder. In upholding the Revenue Service's determination, the U.S. Tax Court and the Court of Appeals relied heavily on two salient facts: (1) that the corporation which issued the notes was thinly capitalized; and (2) that the notes had more equity characteristics than debt.

⁶⁹¹*Id.* at 702-703.

⁶⁹²*Id.* at 704.

⁶⁹³*See Plantation Patterns, Inc. v. Commissioner*, 29 T.C.M. 817 (CCH) (1970), *aff'd*, 462 F.2d 712 (5th Cir. 1972).

⁶⁹⁴*See, e.g., Plantation Patterns, Inc.*, 462 F.2d at 716.

U.S. courts have continued to apply the reasoning of *Plantation Patterns* in appropriate circumstances. Application of the doctrine is most often a concern where the nominal debtor is thinly capitalized and cannot obtain outside financing without a guarantee.⁶⁹⁵

⁶⁹⁵See *In re Lane v. United States*, 742 F.2d 1311 (11th Cir. 1984) (funds guaranteed by primary shareholder held debt to guarantor, followed by guarantor's capital contributions to three "S" corporations where corporations were thinly capitalized and continually operated at a loss); *Stoneking v. Commissioner*, 50 T.C.M. (CCH) 1305 (1985) (guaranteed debt held capital contribution by guarantor to closely-held, thinly-capitalized corporation that could not obtain outside financing); Rev. Rul. 79-4, 1979-1 C.B. 150 (loan to corporation considered loan to individual sole-shareholder guarantor, followed by guarantor's capital contribution to corporation where corporation inadequately capitalized); cf. 1997 F.S.A. LEXIS 149 (June 20, 1997) ("The facts before us are clearly distinguishable from the facts before the court in *Plantation Patterns*. Here, the facts clearly indicate that . . . was not thinly capitalized."); 1995 F.S.A. LEXIS 142 (June 5, 1995) ("In determining that the guaranteed debt was, in substance, debt of the shareholder, the *Plantation Patterns* court focused on the financial health of the purported debtor corporation, believing that New Plantation was not adequately capitalized.").

CHAPTER XVI: LIMITATION ON EARNINGS STRIPPING.

A. Background.

1. **Section 163(j) Enacted in 1989.** Section 163(j) was added to the Internal Revenue Code in 1989⁶⁹⁶ to prevent erosion of the U.S. tax base by means of excessive deductions for interest paid by a taxable corporation to a tax exempt (or partially tax-exempt) related person.⁶⁹⁷ (The payment of excessive deductible interest that is tax exempt (or partially tax exempt) in the hands of a related person is referred to as “earnings stripping.”⁶⁹⁸) Section 163(j), as originally enacted, addresses the use of earnings stripping for interest paid by a U.S. corporation (with a debt-equity ratio of in excess of 1.5 to 1) to a foreign related party, by limiting the amount of deductible interest in a year to no more than 50 percent of an adjusted taxable income amount.⁶⁹⁹

2. **Issuance of Proposed Regulations in 1991.** In 1991, Treasury issued proposed regulations under Section 163(j).⁷⁰⁰ The regulations have never been finalized.

3. **Amendment to Section 163(j) in 1993.** In 1993, Congress amended Section 163(j) by adding an additional limitation on the deductibility of interest on certain loans from unrelated lenders.⁷⁰¹ Under the 1993 Amendment, interest paid on a loan from an unrelated party generally is treated under the earnings stripping rules in the same manner as interest paid to a related person with respect to which no U.S. tax is imposed if no gross-basis U.S. income tax is imposed on the interest (whether or not the interest recipient is subject to net-basis U.S. income tax with respect to that interest), a related person guaranteed the loan, and the related person is either exempt from U.S. Federal income tax or is a foreign person.⁷⁰² Exceptions apply where the taxpayer controls the guarantor, and in cases, identified by regulation, where the interest on the indebtedness would have been subject to net basis tax if the interest had been paid to the guarantor.⁷⁰³

4. **Amendment to Section 163(j) in 2000.** In 2000, Congress amended Section 163(j) by adding a provision providing that interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of Section 163(j).⁷⁰⁴ Thus, the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50% of the subsidiary’s adjusted gross income.⁷⁰⁵ This amendment is effective for taxable years beginning after December 31, 2000. This amendment is not addressed in this outline.

⁶⁹⁶The Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106,

⁶⁹⁷H.R. Rep. No. 247, 101st Cong., 1st Sess. 1240-1250 (1989), *reprinted in* 1989 U.S.C.C.A.N. 2710-2720.

⁶⁹⁸Congressional Committee Reports; Notice of Proposed Rulemaking INTL-0870-89 (June 12, 1991).

⁶⁹⁹H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 63-71 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018.

⁷⁰⁰Notice of Proposed Rulemaking INTL-0870-89 (June 12, 1991).

⁷⁰¹H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 631 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1320.

⁷⁰²I.R.C. § 163(j)(3)(B), 163(j)(6)(D)(i); H.R. Conf. Rep. No. 213, *supra* at n. 475.

⁷⁰³I.R.C. § 163(j)(6)(D)(ii); H.R. Conf. Rep. No. 213, *supra* at n. 475.

⁷⁰⁴I.R.C. § 163(j)(3)(C); S. Rep. No. 201, 106th Cong., 1st Sess. (1999).

⁷⁰⁵I.R.C. § 163(j)(3)(C); *see* S. Rep. No. 201, 106th Cong., 1st Sess., 59-60, H.R. Conf. Rep. No. 478 at 178.

B. General Operation of Section 163(j). Section 163(j) will apply to a U.S. corporation for a tax year only if three elements are present: (1) the debt-to-equity ratio of the company at the close of the year exceeds 1.5 to 1;⁷⁰⁶ (2) the company pays or accrues “disqualified interest” during the tax year;⁷⁰⁷ and (3) the total “net interest expense” of the company exceeds 50% of its “adjusted taxable income” plus any “excess interest limitation carryforward” to such year.⁷⁰⁸

1. Debt-to-Equity Ratio Exceeds 1.5 to 1. Section 163(j) applies only if the company’s debt-to-equity ratio at the close of the tax year exceeds 1.5 to 1.⁷⁰⁹ Under Section 163(j), a company’s debt-to-equity ratio is the ratio of total debt of the company to the equity of the company.⁷¹⁰

a. Definition of Total Debt. The proposed regulations define the debt of a corporation generally as its liabilities determined according to generally applicable tax principles.⁷¹¹ “Short-term liabilities,” however, are excluded from characterization as debt.⁷¹²

b. Definition of Equity. Equity is the sum of money plus the adjusted tax basis of other assets less total debt (but not below zero).⁷¹³ The proposed regulations provide that the amount of a taxpayer’s equity is reduced (but not below zero) by the amount of short-term liabilities excluded from characterization as debt.⁷¹⁴

2. Company Pays or Accrues “Disqualified Interest” During Tax Year. Section 163(j) applies only if the U.S. company pays or accrues disqualified interest during the tax year.

a. Definition of “Disqualified Interest.” “Disqualified interest” is defined as:

(1) Any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no U.S. tax is imposed with respect to such interest;⁷¹⁵ and

(2) Any interest paid or accrued by the taxpayer with respect to any indebtedness to a person who is not a related person (for example, a U.S. bank) if:

(a) There is a guarantee of such indebtedness by a foreign related person,⁷¹⁶ and

⁷⁰⁶I.R.C. § 163(j)(2)(A)(ii).

⁷⁰⁷I.R.C. § 163(j)(1)(A).

⁷⁰⁸I.R.C. §§ 163(j)(2)(A)(i), 163(j)(2)(B)(i).

⁷⁰⁹I.R.C. § 163(j)(2)(A)(ii); *cf.* Prop. Reg. § 1.163(j)-1(b).

⁷¹⁰I.R.C. § 163(j)(2)(C); *cf.* Prop. Reg. § 1.163(j)-3(a).

⁷¹¹Prop. Reg. § 1.163(j)-3(b)(1).

⁷¹²Prop. Reg. § 1.163(j)-3(b)(2).

⁷¹³I.R.C. § 163(j)(2)(C); *Cf.* Prop. Reg. § 1.163(j)-3(c)(1).

⁷¹⁴Prop. Reg. § 1.163(j)-3(c)(3).

⁷¹⁵I.R.C. § 163(j)(3)(A).

(b) No gross basis U.S. tax (i.e., a withholding tax) is imposed with respect to such interest.⁷¹⁷

In the case of a guarantee by a foreign related person of a U.S. corporate indebtedness to a U.S. bank, any interest paid or accrued with respect to such indebtedness would be disqualified interest because no U.S. withholding tax is imposed on interest payments to the U.S. bank. (The bank is subject to tax on a net basis with respect to interest payments received.)⁷¹⁸

b. Definition of “Related Person.” Generally, for purposes of Section 163(j), a recipient is treated as related to the payor of the interest if the recipient and payor would be treated as related under the rules of Section 267(b) or subject to the controlled partnership rules of Section 707(b)(1).⁷¹⁹ Special rules apply to interest paid to partnerships.⁷²⁰

3. “Net Interest Expense” of Company Exceeds 50% of “Adjusted Taxable Income” Plus “Excess Interest Limitation Carryforward.” Section 163(j) applies to a U.S. company only if the net interest expense of the company exceeds (such excess hereinafter referred to as “excess interest expense”) the sum of (i) 50% of its adjusted taxable income, and (ii) any “excess interest limitation carryforward.”⁷²¹

a. Definition of “Net Interest Expense.” The net interest expense of the company is the excess of interest paid or accrued by the company for the tax year, over interest income of the company for the tax year.⁷²²

b. Definition of Adjusted Taxable Income. Generally, “adjusted taxable income” is taxable income computed without regard to any deduction for net interest expense, net operating losses, or any deductions allowable for depreciation, amortization, or depletion.⁷²³

c. Excess Interest Limitation Carryforward. The excess interest limitation carryforward is generated in any year in which 50% of the company’s adjusted taxable income exceeds its net interest expense.⁷²⁴ In such a case, the company is treated as having excess limitation for that year and that excess limitation may be carried forward for three years.⁷²⁵ The amount of carryforwards taken into account for a year succeeding the excess

⁷¹⁶I.R.C. § 163(j)(3)(B)(i).

⁷¹⁷I.R.C. § 163(j)(4)(B)(ii).

⁷¹⁸See H.R. Rep. No. 111, 103rd Cong., 1st Sess. 680-687 (1993), *reprinted in* 1993 U.S.C.C.A.N. 911-918.

⁷¹⁹I.R.C. § 163(j)(4)(A).

⁷²⁰I.R.C. § 163(j)(4)(B)(i).

⁷²¹I.R.C. §§ 163(j)(2)(A)(i), 163(j)(2)(B)(i).

⁷²²I.R.C. § 163(j)(6)(B).

⁷²³I.R.C. § 163(j)(6)(A).

⁷²⁴I.R.C. § 163(j)(2)(B)(iii)(I).

⁷²⁵I.R.C. § 163(j)(2)(B)(ii); *Cf.* Prop. Reg. § 1.163(j)-2(c).

limitation year, however, cannot exceed the excess interest expense for that succeeding year (determined without regard to carryforwards from taxable years that had excess limitation).⁷²⁶

d. All Members of “Affiliated Group” Are Treated as One Taxpayer. For purposes of applying Section 163(j), all members of the same affiliated group are treated as one taxpayer.⁷²⁷ Section 163(j) does not address how the statute should be applied in an affiliated group context; however, the IRS has issued proposed regulations with respect to the application of Section 163(j) to members of an affiliated group.⁷²⁸ Prop. Reg. Section 1.63(j)-5(b) addresses the application of the rules of Section 163(j) to consolidated groups. Prop. Reg. Section 1.63(j)-5(c) provides comparable rules applicable to other affiliated groups.⁷²⁹

4. If Section 163(j) Applies to a Corporation, What Are the Consequences? If all of the elements of Section 163(j) are met and Section 163(j) applies, the amount disallowed will be the lesser of the corporation’s “excess interest expense” or its “disqualified interest” expense.⁷³⁰ Disallowed interest expense may be carried forward and can be deducted in future years to the extent of “excess limitation” in the carryover year.⁷³¹ As a result, Section 163(j) does not necessarily cause a permanent loss of the deduction for disallowed interest expense. Rather, it defers the deduction to a later time when the taxpayer has sufficient taxable income to allow the disallowed interest to be deducted.

C. Examples.

1. Example 1. Assume that for 1990 a corporation has \$150 of adjusted taxable income and \$60 of net interest expense. Assume that for 1991 the corporation has \$100 of adjusted taxable income and again \$60 of net interest expense. Assume that for 1992 the corporation again has \$100 of adjusted taxable income and \$60 of net interest expense.

a. Consequences in 1990. The corporation is not subject to disallowance of interest deductions for 1990 under Section 163(j). Moreover, it has excess limitation for 1990 of \$15 (i.e., 50% of adjusted taxable income (50% of \$150 = \$75), over net interest expense (\$60)).⁷³²

b. Consequences in 1991. For 1991, the sum of 50% of adjusted taxable income (\$50), plus the excess limitation carryforward from 1990 that may be taken into account for 1991, equals \$60 (i.e., \$50 (representing 50% of adjusted taxable income) plus \$10 (only \$10 of excess limitation carryforward is utilized because net interest expense is \$60)).

⁷²⁶I.R.C. § 163(j)(2)(B)(ii).

⁷²⁷I.R.C. § 163(j)(6)(C).

⁷²⁸See Prop. Reg. § 1.163(j)-5.

⁷²⁹Notice of Proposed Rulemaking, Reg-2090S9-89 [originally issued as INTL-0870-89] published June 13, 1991 (CCH 49,161).

⁷³⁰I.R.C. § 163(j)(1)(A).

⁷³¹I.R.C. § 163(j)(1)(B); Prop. Reg. §§ 1.163(j)-1(a)(3), 1.163(j)-1(c)(1).

⁷³²H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

Therefore, the corporation is not subject to disallowance of interest deductions for 1991 under Section 163(j).⁷³³

c. Consequences in 1992. For 1992, the sum of 50% of adjusted taxable income, plus the excess limitation carryforward from 1990 that may be taken into account for 1992, equals \$55 (*i.e.*, \$50 (representing 50% of adjusted taxable income) plus \$5 (\$5 remaining excess limitation carryforward is utilized)). Therefore, the corporation may be subject to disallowance of up to \$5 of interest deductions for 1992 under Section 163(j), assuming that it has paid or incurred disqualified interest for 1992 and assuming that its debt-to-equity ratio for that year exceeds 1.5 to 1.⁷³⁴

2. Example 2. Under Section 163(j)(5)(B), if a treaty between the U.S. and any foreign country reduces the rate of U.S. tax imposed on interest that the taxpayer pays to a related person, the person is treated as tax exempt (and the interest is treated as disqualified interest) to the extent of the same proportion of such interest paid or accrued as the treaty's rate reduction (from the 30% rate) bears to the 30% rate.⁷³⁵ For example, a U.S. corporation is a subsidiary of a Japanese parent corporation. Under the U.S./Japan Treaty, interest payments are generally subject to a 10% withholding tax (in lieu of the general 30% rate). The U.S. corporation, which has no interest income, has \$50 of adjusted taxable income. It pays \$90 of interest expense, all of which is paid to its Japanese parent. That \$90 interest payment, which is subject to a \$9 withholding tax, is subject to tax at one-third the normal rate (*i.e.*, the ratio of 10% to 30%). That is, two thirds (\$60) of the \$90 interest payment is tax exempt. Therefore, two-thirds (\$60) of the \$90 interest payment is treated as disqualified interest, while one-third (\$30) of the \$90 is not disqualified interest. Deductions for disqualified interest are disallowed to the extent that net interest expense exceeds (i) 50% of adjusted taxable income, plus (2) any excess limitation carryforward (assume \$0 in this case). The net interest expense of \$90 exceeds 50% of adjusted taxable income (\$25) by \$65. Inasmuch as \$60 of disqualified interest is less than the \$65 excess, only \$60 is disallowed. A current deduction is allowed for the remaining \$30 of related party interest.⁷³⁶

⁷³³H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

⁷³⁴H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

⁷³⁵I.R.C. § 163(j)(5)(B).

⁷³⁶H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

CHAPTER XVII: SECTION 267(a)(3)

Section 267(a)(3) and the regulations thereunder require a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person.⁷³⁷ An amount is treated as paid if the amount is considered paid for purposes of sections 1441 and 1442. An amount that is owed to a related foreign person and that is otherwise deductible thus may not be deducted by the taxpayer until such amount is paid to the related foreign person.⁷³⁸

⁷³⁷Treas. Reg. § 1.267(a)-3(b)(1).

⁷³⁸Treas. Reg. § 1.267(a)-3(b)(1).

CHAPTER XVIII: ANTI-DEFERRAL MECHANISMS APPLICABLE TO U.S. INVESTORS IN FOREIGN CORPORATIONS

A. Controlled Foreign Corporations.

1. Statutory Pattern of Taxation. Each U.S. shareholder of a controlled foreign corporation (“CFC”) is generally required to include in income for U.S. federal income tax purposes his pro rata share of certain categories of income of the CFC, even though undistributed.⁷³⁹ Such inclusions of undistributed CFC earnings are generally triggered by two different provisions of the CFC rules. Under one such provision, the U.S. shareholder is required to include his pro rata share of the CFC’s “Subpart F income” earned during the year.⁷⁴⁰ The second provision requires a U.S. shareholder to include his pro rata share of the CFC’s earnings that are invested in certain U.S. property for the year.⁷⁴¹ If one of these provisions is triggered, the income is includable for the U.S. shareholder’s tax year within which the tax year of the CFC ends.⁷⁴²

2. Classification as a Controlled Foreign Corporation. A foreign corporation is a “controlled foreign corporation” if more than 50% of (a) the total combined voting power of all classes of voting stock, or (b) the total value of the stock of the corporation, is owned by U.S. shareholders on any day during the tax year.⁷⁴³ A “U.S. shareholder” for this purposes is a U.S. person who owns 10% or more of the total combined voting power of all classes of voting stock of the corporation.⁷⁴⁴ In determining whether a foreign corporation is a CFC and whether a U.S. person is a U.S. shareholder, certain complex ownership attribution rules apply.⁷⁴⁵

3. Subpart F Income.

a. “Subpart F Income” Includes Five Categories of Income. The Subpart F income of a CFC is the sum of the following categories of income:⁷⁴⁶

- (1) Insurance income;
- (2) Foreign base company income which includes:
 - (a) Foreign personal holding company income;
 - (b) Foreign base company sales income;

⁷³⁹I.R.C. § 951(a).

⁷⁴⁰I.R.C. § 951(a)(1)(A)(i).

⁷⁴¹I.R.C. § 951(a)(1)(B).

⁷⁴²I.R.C. § 951(a)(1).

⁷⁴³I.R.C. § 957(a); *see also* Treas. Reg. § 1.957-1(b)(1) (“combined voting power” defined); Treas. Reg. § 1.957-1(b)(2) (“Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained.”).

⁷⁴⁴I.R.C. § 951(b); *see also* Treas. Reg. § 1.951-1(b)(2) (“combined voting power” defined).

⁷⁴⁵I.R.C. §§ 958(a), 958(b).

⁷⁴⁶I.R.C. § 952(a).

- (c) Foreign base company services income; and
- (d) Foreign base company oil related income;
- (3) International boycott-related income;
- (4) The sum of any illegal payments paid by the CFC to an official of a foreign government; and
- (5) Income derived from (i) countries whose governments support terrorism; (ii) countries that do not have diplomatic relations with the U.S.; and (iii) countries that are not recognized by the U.S.⁷⁴⁷

b. Income Excludable from Subpart F income. Subpart F income does not include any United States-sourced income which is effectively connected with the conduct of a trade or business by the CFC within the U.S. unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the U.S.⁷⁴⁸

c. Subpart F Income Limited to Current Earnings and Profits of a CFC. The Subpart F income of a CFC is generally limited to the current earnings and profits of the CFC for the year.⁷⁴⁹

d. Description of “Foreign Base Company Income.” “Foreign base company income” generally means the sum of the following categories of income of the CFC: (1) the foreign personal holding company income; (2) the foreign base company sales income; (3) the foreign base company services income; and (4) the foreign base company oil related income.⁷⁵⁰

(1) Exclusions and Special Rules Applicable in Computing Foreign Base Company Income. Certain exclusions and special rules apply in computing foreign base company income, including the following:

(a) De Minimis Rule. No part of the gross income of a CFC is foreign base company income if the sum of the gross foreign base company income and the gross insurance income for the taxable year is less than the lesser of: (i) 5 percent of gross income of the CFC, or (ii) \$1,000,000.⁷⁵¹

(b) Full Inclusion Rule. If the sum of the foreign base company income and the gross insurance income for the tax year exceeds 70 percent of gross income, the entire gross income for the tax year (with certain exceptions for income subject to high foreign taxes) is treated as foreign base company income or insurance income (whichever is

⁷⁴⁷I.R.C. § 952(a)(5); I.R.C. § 901(j).

⁷⁴⁸I.R.C. § 952(b).

⁷⁴⁹I.R.C. § 952(c)(1)(A).

⁷⁵⁰I.R.C. § 954(a) (as amended by the American Jobs Creation Act of 2004).

⁷⁵¹I.R.C. § 954(b)(3)(A).

appropriate). If a CFC's entire gross income is treated as foreign base company income under this rule, deductions may, nevertheless, be taken into account as discussed below.⁷⁵²

(c) Exception for Income Subject to High Foreign

Taxes. Foreign base company income and insurance income do not include any item of income received by a CFC if the income was subject to an effective rate of income tax imposed by a foreign country of greater than 90 percent of the maximum U.S. corporate income tax rate. This exception, however, does not apply to foreign based oil-related income.⁷⁵³

(d) Deductions to be Taken into Account.

Each component part of foreign base company income is reduced so as to take into account deductions (including taxes) properly allocable to such income.⁷⁵⁴ U.S. federal income taxes, however, are not deductible from gross foreign base company income.⁷⁵⁵

(2) Foreign Personal Holding Company Income.

"Foreign personal holding company income" ("FPHCI") generally means the portion of a CFC's gross income which consists of dividends, interest, royalties, rents, annuities, and net gains from the sale or exchange of property giving rise to such passive income.⁷⁵⁶ FPHCI, however, does not include rents and royalties which are derived in the active conduct of a trade or business and which are received from an unrelated person.⁷⁵⁷

(3) Foreign Base Company Sales Income.

"Foreign base company sales income" means income (whether in the form of profits, commissions, fees or otherwise) derived in connection with a transaction which has three elements: (a) the related-party element; (b) the manufacturing element; and (c) the use element.

(a) The Related-Party Element.

A transaction has a related-party element if it is described as follows:

- i) The purchase of personal property from a related person and its sale to any person;
- ii) The sale of personal property to any person on behalf of a related person;
- iii) The purchase of personal property from any person and its sale to a related person;
- iv) The purchase of personal property from any person on behalf of a related person.

⁷⁵²I.R.C. § 954(b)(3)(B).

⁷⁵³I.R.C. § 954(b)(4).

⁷⁵⁴I.R.C. § 954(b)(5).

⁷⁵⁵I.R.C. § 275(a)(1).

⁷⁵⁶I.R.C. § 954(c)(1).

⁷⁵⁷I.R.C. § 954(c)(2)(A).

(b) The Manufacturing Element. A transaction has a manufacturing element if the property which is purchased by the CFC (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured or produced outside the country of incorporation of the CFC.⁷⁵⁸

(c) The Use Element. In general, a transaction has a use element if the property is sold for use, consumption, or disposition outside the country of incorporation of the CFC, or, in the case of property purchased on behalf of a related person, the property is purchased for use, consumption, or disposition outside the country of incorporation of the CFC.⁷⁵⁹

(4) Certain Branch Income. If a CFC manufactures goods in its country of incorporation, but sells the goods from a branch office in another foreign country, the income attributable to the branch may be treated as income derived by a wholly-owned subsidiary of the CFC and will constitute foreign base company sales income of the CFC.⁷⁶⁰ If a CFC manufactures goods at a branch outside of its company of incorporation and the goods are sold from a sales office in its country of incorporation, the branch may be treated as a separate corporation for purposes of determining foreign base company sales income.⁷⁶¹

e. Foreign Base Company Services Income.

(1) General Definition. “Foreign base company services income” means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which meet two elements: (a) the related-party element; and (b) the foreign country element.

(a) Related-Party Element. The related-party element is met if the services are performed for or on behalf of any related person.⁷⁶²

(b) Foreign Country Element. The foreign country element is met if the services are performed outside the country of incorporation of the CFC.⁷⁶³

(2) Certain Income Not Included. Foreign base company services income does not include income derived in connection with the performance of the following:

(a) Services relating to the sale or exchange of property manufactured or produced which are performed before the time of the sale or exchange; or

⁷⁵⁸I.R.C. § 954(d)(1)(A).

⁷⁵⁹I.R.C. § 954(d)(1)(B).

⁷⁶⁰I.R.C. § 954(d)(2).

⁷⁶¹Treas. Reg. § 1.954-3(b)(1)(ii).

⁷⁶²I.R.C. § 954(e)(1)(A).

⁷⁶³I.R.C. § 954(e)(1)(B).

(b) Services relating to the offer or effort to sell or exchange property manufactured or produced.⁷⁶⁴

f. Foreign Base Company Oil-Related Income.

(1) Items Included Within “Foreign Base Company Oil-Related Income.” The term “foreign base company oil-related income” generally means the taxable income derived from sources outside the United States and its possessions from the following:

- (a) The processing of minerals extracted from oil or gas wells into their primary product;
- (b) The transportation of such minerals or primary products;
- (c) The distribution or sale of such minerals or primary products;
- (d) The disposition of assets used by the taxpayer in the trade or business described in paragraphs (a), (b), or (c);
- (e) The performance of any other related service; and
- (f) Certain amounts received or deemed to be received from certain foreign corporation and partnerships, to the extent such amounts are attributable to income described in paragraphs (a), (b), (c), (d) and (e).⁷⁶⁵

(2) Income Excluded from Foreign Base Company Oil-Related Income. Foreign base company oil-related income does not include income derived from a source within a foreign country in connection with the following:

- (a) Oil or gas which is extracted from a well located in that foreign country; or
- (b) Oil, gas, or a primary product of oil or gas which is sold for use or consumption within such foreign country or is loaded in the foreign country in a vessel or aircraft for use as fuel.⁷⁶⁶

(3) Exemption for Small Oil Producers. Foreign base company oil-related income does not include any income of a foreign corporation if the average

⁷⁶⁴I.R.C. § 954(e).

⁷⁶⁵I.R.C. § 954(g)(1).

⁷⁶⁶I.R.C. § 954(g)(1).

daily production of foreign crude oil and natural gas by the foreign corporation and any related persons for the tax year and immediately preceding tax year is less than 1,000 barrels.⁷⁶⁷

4. Increase in Earnings Invested in U.S. Property. If a CFC invests in certain “U.S. property,” each U.S. shareholder in the CFC is generally required to include the U.S. shareholder’s pro rata share of the CFC’s earnings invested in U.S. property for the year (computed by taking the average of the adjusted bases of U.S. property held by the CFC as of the close of each quarter of the year, less any liability to which the property is subject), but only to the extent that the earnings have not been previously included in the U.S. shareholder’s income.⁷⁶⁸ The amount includible is limited to the U.S. shareholder’s pro rata share of the CFC’s current (as reduced by current-year distributions) and accumulated earnings and profits, reduced by the portion of the earnings of the CFC previously included in the income of the U.S. shareholder.⁷⁶⁹

“U.S. property” for this purpose generally includes (with certain exceptions) tangible property located in the U.S., certain stock in U.S. corporations,⁷⁷⁰ and certain obligations of a U.S. person.⁷⁷¹ A CFC will be considered as holding an obligation of a U.S. person if the CFC is a pledgor or guarantor on the obligation.⁷⁷² In addition, if the assets of a CFC serve at any time, even though indirectly, as security for the performance of an obligation of a U.S. person, the CFC will be considered a pledgor or guarantor of that obligation. For this purpose, the pledge of CFC stock will be considered as an indirect pledge of the assets of the CFC if the following two conditions are met:

- a. At least 66 2/3 percent of the total voting stock is pledged; and
- b. The pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the discretion of the CFC with respect to the disposition of assets or the incurrence of liabilities other than in the ordinary course of business.⁷⁷³

U.S. property also includes any right to the use in the U.S. of a patent, copyright, invention, model, design, secret formula or process, or any other similar right, which is acquired or developed by the CFC for use in the U.S.⁷⁷⁴ U.S. Property includes any trade or service receivable if the following two conditions are met:

- c. The trade or service receivable is acquired from a related person who is a U.S. person; and

⁷⁶⁷I.R.C. § 954(g)(2).

⁷⁶⁸I.R.C. § 956(a).

⁷⁶⁹I.R.C. § 956(a).

⁷⁷⁰I.R.C. § 956(c)(2)(F).

⁷⁷¹I.R.C. § 956(c)(1)(C).

⁷⁷²I.R.C. § 956(d).

⁷⁷³Treas. Reg. § 1.956-2(c)(2).

⁷⁷⁴I.R.C. § 956(c)(1)(D).

d. The obligor under the receivable is a U.S. person.⁷⁷⁵

5. **Tax Year of a CFC.** Section 898 of the Code generally requires the taxable year of a controlled foreign corporation to conform (for U.S. tax purposes) to the tax year of each “Majority U.S. Shareholder.”⁷⁷⁶

B. Passive Foreign Investment Company. Certain U.S. shareholders in a “passive foreign investment company” (“PFIC”) are generally required to pay U.S. federal income tax plus an interest charge based on the value of tax deferral at the time the shareholder (i) receives certain “excess distributions” from the PFIC; or (ii) disposes of his or her stock in the PFIC.⁷⁷⁷ This general rule, however, does not apply to U.S. shareholders in PFICs that are classified as “qualified electing funds.”⁷⁷⁸

1. **Classification as a PFIC.** A “PFIC” means any foreign corporation which meets (i) the “passive income test;” or (ii) the “passive asset test.”⁷⁷⁹

a. **Passive Income Test.** The passive income test is met if 75 percent or more of the gross income of the corporation for the tax year is passive income. “Passive income” generally means that portion of the gross income of the corporation which consists of dividends, interest, royalties, rents, annuities, and net gains from the sale or exchange of property giving rise to such passive income. Certain exclusions to the definition of passive income are listed in Section 1297(b)(2).

b. **Passive Asset Test.** The passive asset test is met if the average percentage of “passive assets” (by value or, in certain cases, adjusted tax basis) held by the corporation during the tax year is at least 50 percent.⁷⁸⁰ A “passive asset” is any asset which produces passive income or which is held for the production of income.⁷⁸¹

2. Consequences of PFIC Classification.

a. Treatment of Excess Distributions from PFIC.

(1) **Computation of Tax on an “Excess Distribution.”** If a U.S. person receives an “excess distribution” in respect of stock in a PFIC, gain recognized on receipt of the “excess distribution” is considered to be earned pro rata over the shareholder’s holding period of his investment. Under this rule, U.S. tax due in the year of receipt of an “excess distribution” is the sum of the following amounts:

⁷⁷⁵I.R.C. § 956(c)(3).

⁷⁷⁶See Rev. Proc. 90-26, 1990-1 C.B. 512 (guidance provided with respect to the required tax year under Section 898).

⁷⁷⁷I.R.C. § 1291.

⁷⁷⁸See I.R.C. §§ 1291-1297.

⁷⁷⁹I.R.C. § 1297(a); see Notice 88-22, 1988-1 C.B. 489, *modified by* Notice 89-81, 1989-2 C.B. 399 (guidance concerning the application of the passive income test and passive asset test).

⁷⁸⁰I.R.C. § 1297(a).

⁷⁸¹I.R.C. § 1297(a); I.R.C. § 1297(e).

(a) U.S. tax computed using the highest rate of U.S. tax for the investor (without regard to other income or expenses the investor may have) on gain attributed to prior years; plus

(b) Interest imposed on the deferred tax; plus

(c) U.S. tax on the gain attributed to the year of receipt and to years in which the foreign corporation was not a PFIC (for which no interest is due).⁷⁸²

(2) What Is an “Excess Distribution?” An “excess distribution” means any current year distribution to the extent that it represents a ratable portion of the total distributions during the year that are in excess of the “125% Amount.” The “125% Amount” is an amount equal to 125 percent of the average amount of distributions during the three years preceding the year of distribution (or, if shorter, the portion of the taxpayer’s holding period before the tax year).⁷⁸³

b. Treatment of Dispositions. If a U.S. person disposes of stock in a PFIC, then any gain recognized will be subject to the rules of excess distribution in the same manner as if the gain were an excess distribution. The total excess distributions with respect to any stock is zero for the year in which the taxpayer’s holding period in such stock begins.⁷⁸⁴

3. Qualified Electing Funds. If a U.S. shareholder in a PFIC elects to treat the PFIC as a qualified electing fund (“QEF”), such shareholder is required to include currently in gross income his pro rata share of certain of the PFIC’s earnings.⁷⁸⁵ An electing shareholder is required to include his pro rata share of the following in income:

a. Ordinary income for the PFIC’s tax year; and

b. Net capital gain (not exceeding earnings and profits) for the PFIC’s tax year (which may be treated as capital gain income).⁷⁸⁶

A pro rata share is the amount which would have been distributed with respect to the shareholder’s stock if the fund had distributed to each shareholder a pro rata share of that day’s ratable share of the PFIC’s ordinary earnings and net capital gain for the year.⁷⁸⁷

⁷⁸²I.R.C. § 1291(a)(1).

⁷⁸³I.R.C. § 1291(b)(1), (2).

⁷⁸⁴I.R.C. § 1291(b)(2)(B).

⁷⁸⁵I.R.C. § 1293(a).

⁷⁸⁶I.R.C. § 1293(a)(1).

⁷⁸⁷I.R.C. § 1293(b).

C. Other Statutory Mechanisms Imposed to Curtail Deferral of Income.

1. Accumulated Earnings Tax Rules. The accumulated earnings tax (“AET”) is applicable to any foreign corporation with respect to U.S. source income if any of its shareholders are subject to U.S. federal income tax on the distributions of the corporation by reason of being one of the following:

- a.** U.S. citizens or residents;
- b.** Nonresident aliens subject to U.S. federal income tax under Section 871 of the Code; or
- c.** Foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in (a) or (b).⁷⁸⁸

The AET is generally imposed on accumulated taxable income of a corporation. The accumulated taxable income of a foreign corporation which files a return is the corporation’s taxable income from U.S. sources (with certain adjustments) minus the sum of the dividends paid deduction and the accumulated earnings credit. If the corporation fails to file a return, the accumulated taxable income is the gross income from U.S. sources without allowance of any deductions.⁷⁸⁹

D. Coordination of Anti-Deferral Mechanisms. The Internal Revenue Code coordinates the application of the anti-deferral mechanisms to prevent the double inclusion of income.⁷⁹⁰

⁷⁸⁸See Treas. Reg. § 1.532-1(c).

⁷⁸⁹I.R.C. § 535(b).

⁷⁹⁰See, e.g., I.R.C. §§ 951(c) (as amended by the American Jobs Creation Act of 2004), 532(b)(3), 1297(d).

CHAPTER XIX: THE DIRECT FOREIGN TAX CREDIT

A. Tax Treatment of Foreign Taxes — In General. If a U.S. taxpayer pays or accrues foreign income taxes during the tax year, the U.S. taxpayer may elect to either: (1) deduct the amount of the foreign income taxes from gross income for U.S. federal income tax purposes; or (2) claim the amount of the foreign income taxes as a credit against U.S. federal income taxes due.⁷⁹¹ There are generally six issues to analyze in determining whether the foreign tax credit is available to a taxpayer:

1. Is the taxpayer eligible to claim the foreign tax credit?
2. Is the tax a creditable tax?
3. Who is the taxpayer that should claim the foreign tax credit?
4. Do any special limitations apply which may reduce the amount of the credit?
5. Does the overall limitation on the foreign tax credit under Section 904 limit the amount of the creditable taxes?
6. What is the time and manner for claiming the foreign tax credit?

B. Analysis of Six Issues.

1. **Is the Taxpayer Eligible to Claim the Foreign Tax Credit?** The following persons are allowed a foreign tax credit subject to certain limitations:⁷⁹²

- a. U.S. citizens and domestic corporations;
- b. Residents of the U.S. or Puerto Rico;
- c. Nonresident alien individuals and foreign corporations under certain circumstances; and
- d. Partners or individual beneficiaries of an estate that are described in the categories a through c above.⁷⁹³

2. **Is the Tax a Creditable Tax?** For a tax paid to qualify for the foreign tax credit, it must generally constitute either (i) an income tax, a war profits tax or an excess profits tax; or (ii) a tax in lieu of a tax on income, war profits or excess profits.⁷⁹⁴ A foreign levy is a

⁷⁹¹I.R.C. §§ 275(a), 901.

⁷⁹²I.R.C. § 901(b).

⁷⁹³I.R.C. § 901(b)(5) (as amended by the American Jobs Creation Act of 2004); *see also* I.R.C. § 1373(a) (S corporation is treated as a partnership and the shareholders of an S corporation are treated as partners of a partnership).

⁷⁹⁴I.R.C. §§ 901(a), 901(b), 903.

tax if it requires a compulsory foreign payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. A foreign levy is not a tax to the extent a person receives a specific economic benefit in exchange for payment of the levy.⁷⁹⁵

a. Predominant Character of Tax Must be that of an Income Tax in the U.S. Sense. A foreign levy is an income tax if and only if (i) it is a tax; and (ii) the predominant character of that tax is that of an income tax in the U.S. sense.⁷⁹⁶ The predominant character of a tax is that of an income tax in the U.S. sense if the tax meets two requirements: (i) the tax is likely to reach net gain in the normal circumstances in which it applies; and (ii) liability for the tax is not dependent on the availability of a credit for the tax against income tax liability to another country.⁷⁹⁷

b. Tax in Lieu of an Income Tax. Section 903 generally provides that a foreign tax credit is allowed for a tax paid in lieu of a tax on income, war profits or excess profits which is otherwise generally imposed by a foreign country. A foreign levy is a tax in lieu of an income tax if and only if (i) it is a tax; and (ii) it meets a substitution requirement.⁷⁹⁸ The substitution requirement is met if the tax imposed is in substitution for, and not in addition to, an income tax.⁷⁹⁹

3. Who Is the Taxpayer that Should Claim the Foreign Tax Credit? The “person who pays the tax” is the person on whom the foreign law imposes the legal liability for tax, even if another person (for example a withholding agent) remits the tax.⁸⁰⁰

4. Do Any Special Limitations Apply that May Reduce the Amount of the Credit? Certain special limitations generally applicable to foreign income taxes paid on foreign mineral income may reduce the amount of the foreign tax credit.⁸⁰¹ A discussion of these special limitations is beyond the scope of this outline.

5. Does the Overall Limitation on the Foreign Tax Credit under Section 904 Limit the Amount of the Creditable Taxes? Section 904 of the Code limits the amount of a taxpayer’s creditable foreign taxes for the year.

a. Computation of Limitation. The limitation is computed as follows:

$$\text{Pre-credit U.S. tax} \times \frac{\text{Foreign source taxable income}}{\text{Total U.S. taxable income}}$$

⁷⁹⁵Treas. Reg. § 1.901-2(a)(2)(i).

⁷⁹⁶Treas. Reg. § 1.901-2(a)(1).

⁷⁹⁷Treas. Reg. § 1.901-2(a)(3); *see also* Treas. Reg. § 1.901-2(b)(1) (circumstances under which foreign tax is likely to reach net gain).

⁷⁹⁸Treas. Reg. § 1.903-1(a).

⁷⁹⁹Treas. Reg. § 1.903-1(b).

⁸⁰⁰Treas. Reg. § 1.901-2(f)(1); *see also* Rev. Rul. 57-516, 1957-2 C.B. 435 (U.S. shareholders of foreign corporations should report, for Federal income tax purposes, gross amount of dividends received from such corporations (i.e., without reduction for withholding taxes) and claim credit for tax paid on dividends).

⁸⁰¹*See* I.R.C. §§ 901(e), 901(f), 907.

b. Application of Limitation Formula. A taxpayer is required to compute a separate foreign tax credit limitation for (1) a passive income category; and (2) a general category.⁸⁰³ Thus, the Section 904(a) limitation formula must be applied separately with respect to each of these categories.

c. Treatment of Separate Basket Losses. If a taxpayer realizes a foreign loss when figuring taxable income in a separate category, and the taxpayer has income in another category, the taxpayer must first reduce the income in other baskets by the foreign loss before offsetting U.S. source income.⁸⁰⁴ Foreign losses must be allocated among the separate categories in the same proportion as each category's income bears to total foreign income.⁸⁰⁵ If (a) a separate basket loss was allocated to income from any other basket, and (b) the loss basket has income for a subsequent year, then income in subsequent years is recharacterized as income from such other basket in proportion to the prior reductions for allocable losses.⁸⁰⁶

d. Recapture of Overall Foreign Loss. If a taxpayer has only losses in separate baskets or if a taxpayer has a loss remaining after allocating foreign losses to other separate baskets, the taxpayer has an "overall foreign loss." If a taxpayer has an "overall foreign loss" for a tax year, the taxpayer's foreign source income in later years is treated as U.S. source income to the extent of the lesser of:

- (1) The amount of the overall foreign loss for the prior year; or
- (2) 50% (or such larger percent as the taxpayer may choose) of the taxpayer's foreign source taxable income.⁸⁰⁷

The balance is suspended and carried forward.⁸⁰⁸

e. Carryback and Carryover of Excess Taxes Paid. If the amount of foreign income taxes paid or accrued to a foreign country or U.S. possession exceeds the Section 904 limitation amount for the tax year, the excess may be carried back one year and carried forward ten years, in that order, and treated as taxes paid in those years (subject to the application of Section 904).⁸⁰⁹

6. What Is the Time and Manner for Claiming the Foreign Tax Credit?

⁸⁰²I.R.C. § 904(a).

⁸⁰³I.R.C. § 904(d).

⁸⁰⁴I.R.C. § 904(f)(5)(A).

⁸⁰⁵I.R.C. § 904(f)(5)(B).

⁸⁰⁶I.R.C. § 904(f)(5)(C).

⁸⁰⁷I.R.C. § 904(f).

⁸⁰⁸I.R.C. § 904(f).

⁸⁰⁹I.R.C. § 904(c).

a. Time. A credit for foreign taxes may generally be claimed in the tax year in which the taxes were paid or accrued, depending on the method of accounting used by a taxpayer. A cash basis taxpayer, however, may elect to claim a credit for foreign taxes accrued. If the election is made, the taxpayer must compute the foreign tax credit for all subsequent years on the same basis.⁸¹⁰

b. Manner. An individual claiming a foreign tax credit must complete and file IRS Form 1116 with his or her Federal income tax return. A corporation claiming a foreign tax credit must complete and file IRS Form 1118 with its Federal income tax return.⁸¹¹

⁸¹⁰I.R.C. § 905; Treas. Reg. § 1.905-1(a).

⁸¹¹Treas. Reg. § 1.905-2(a).

CHAPTER XX: INDIRECT FOREIGN TAX CREDIT

Under the “deemed-paid” or “indirect” foreign tax credit allowed by U.S. tax law, U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation’s earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.⁸¹² By way of example, if a domestic corporation meeting the threshold requirements for claiming an indirect foreign tax credit receives a dividend from a first-tier foreign corporation, the domestic parent corporation is deemed to have paid the amount of post-1986 foreign income taxes paid or deemed paid by the foreign corporation as determined under the following formula:

$$\begin{array}{rcl}
 \begin{array}{l} \text{Dividend} \\ \text{received} \\ \text{by} \\ \text{the U.S.} \\ \text{shareholder} \\ \text{Post-1986} \\ \text{undistributed} \\ \text{earnings of} \\ \text{foreign} \\ \text{corporation} \end{array} & \times & \begin{array}{l} \text{Post-1986 foreign} \\ \text{income taxes paid and} \\ \text{deemed paid by first-} \\ \text{tier foreign} \\ \text{corporation} \end{array} & = & \begin{array}{l} \text{Amount of first-tier foreign} \\ \text{corporation's foreign} \\ \text{income taxes deemed paid} \\ \text{by domestic corporation}^{813} \end{array}
 \end{array}$$

The term “post-1986 undistributed earnings” means current earnings and profits unreduced by current-year distributions plus post-1986 accumulated earnings and profits.⁸¹⁴ The term “post-1986 foreign income taxes” means the sum of the following amounts:

1. The foreign income taxes with respect to the tax year of the foreign corporation in which the dividend is distributed; and
2. The foreign income taxes with respect to prior post-1986 tax years, to the extent such foreign taxes were not attributable to dividends distributed out of the foreign corporation in prior tax years.⁸¹⁵

A U.S. corporation may also be deemed to have paid taxes paid by a first, second or third-tier foreign corporation and, if certain special requirements are satisfied, a fourth, fifth and sixth-tier foreign corporation.⁸¹⁶ No taxes paid by a second, third fourth, fifth or sixth-tier foreign corporation are deemed paid by the first foreign corporation unless certain prescribed

⁸¹²I.R.C. § 902(a).

⁸¹³I.R.C. § 902(a).

⁸¹⁴I.R.C. § 902(c)(1); *see also* I.R.C. § 902(c)(6) (special rules for dividends paid from earnings and profits accumulated for years prior to January 1, 1987).

⁸¹⁵I.R.C. § 902(c)(2).

⁸¹⁶I.R.C. § 902(b).

stock ownership rules are satisfied.⁸¹⁷ A deemed-paid credit generally is also available with subpart F inclusions.⁸¹⁸

A domestic corporation that claims an indirect foreign tax credit for deemed-paid taxes must include the amount of the credit in gross income.⁸¹⁹ The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be “grossed-up”) and included in the U.S. corporate shareholder’s income to treat the shareholder as if it had received its proportionate share of pre-tax profits and paid its proportionate share of foreign tax.⁸²⁰

⁸¹⁷I.R.C. § 902(b)(2)(B).

⁸¹⁸I.R.C. § 960.

⁸¹⁹I.R.C. § 78.

⁸²⁰I.R.C. § 78.

CHAPTER XXI: SECTION 367(A) - TRANSFER OF ASSETS TO A FOREIGN CORPORATION

Section 367(a) generally provides that a foreign corporation will not be considered a corporation for purposes of applying the corporate organization, reorganization, and liquidation rules to a U.S. person's transfer of property to a foreign corporation.⁸²¹ Thus, transfers of property to foreign corporations described in Section 367(a) will generally be treated as taxable exchanges. Section 367(a)(1) denies nonrecognition treatment, however, only with respect to transfers of items of property on which gain is realized. The amount of gain recognized because of Section 367(a)(1) is not affected by the transfer of items of property on which loss is realized but not recognized.⁸²² Thus, under Section 367(a), a taxpayer cannot "net" gains and losses realized on a unitary transfer of property to a foreign corporation. No loss can be recognized through the operation of Section 367.⁸²³

If a U.S. person is required to recognize gain under Section 367(a)(1) upon a transfer of property to a foreign corporation, the character and source of the gain are determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation. In addition, adjustments to earnings and profits, basis, and other affected items must be made according to otherwise applicable rules, taking into account the gain recognized because of Section 367(a)(1).⁸²⁴

The general rule of Section 367(a) does not apply to certain transfers of stock or securities of a foreign corporation⁸²⁵ or to property transfers to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of the United States.⁸²⁶ However, the latter exception does not apply to any inventory, installment obligations, accounts receivable, foreign currency or other property denominated in foreign currency, intangible property, or certain property of which the transferor is a lessor at the time of the transfer.⁸²⁷

Section 367(d) applies to transfers of intangibles by a U.S. person to a foreign corporation. Under Section 367(d), if intangible property is transferred by a U.S. person to a foreign corporation in an exchange described in Section 351 or Section 361, the transferor will be deemed to have sold the property in exchange for annual payments contingent on the productivity or use of such property and received the annual payments over the useful life of the intangible property.⁸²⁸ The amounts deemed to be received under Section 367(d) must be commensurate with the income attributable to the intangible.⁸²⁹

⁸²¹I.R.C. § 367(a)(1).

⁸²²Temp. Treas. Reg. § 1.367(a)-1T(b)(1).

⁸²³Temp. Treas. Reg. § 1.367(a)-1T(b)(3)(ii).

⁸²⁴Temp. Treas. Reg. § 1.367(a)-1T(b)(4).

⁸²⁵I.R.C. § 367(a)(2).

⁸²⁶I.R.C. § 367(a)(3)(A).

⁸²⁷I.R.C. § 367(a)(3)(B).

⁸²⁸I.R.C. § 367(d).

⁸²⁹I.R.C. § 367(d)(2)(A).

To the extent provided in Treasury Regulations, if a U.S. person transfers property to a foreign corporation as paid-in surplus or as a contribution to capital (in a transaction that is not otherwise described in Section 367(a), such transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred.⁸³⁰ The transferor is required to recognize as gain the excess of (i) the fair market value of the property so transferred, over (ii) the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.⁸³¹

⁸³⁰I.R.C. § 367(f).

⁸³¹I.R.C. § 367(f).

CHAPTER XXII: INTERNATIONAL TRANSFER PRICING OF GOODS AND SERVICES

A. The Statute. Section 482 of the Code generally provides that, in the case of two or more businesses controlled by the same interests, the Internal Revenue Service may allocate income, deductions, credits, or allowances between such businesses in order to prevent tax evasion or to reflect income clearly. The IRS may apply Section 482 whether or not the businesses are incorporated, organized in the U.S., or affiliated.⁸³²

Section 482 also provides that, in the case of any transfer (or license) of intangible property, the income with respect to such transfer or license must be commensurate with the income attributable to the intangible.

B. Purpose of Section 482. The purpose of Section 482 is generally to ensure that taxpayers clearly reflect income attributable to transactions between controlled taxpayers. Section 482 attempts to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.⁸³³

C. Use of Section 482 by the IRS and Taxpayers.

1. Use of Section 482 by the IRS. If a controlled taxpayer has not reported its true taxable income, the IRS may reallocate any item affecting taxable income, including items of income, deductions, credits, allowances and basis, among the members of a controlled group.⁸³⁴

a. Intent to avoid or evade taxes not a prerequisite. The application of Section 482 does not require a finding of an intent to avoid or evade taxes in a transaction.⁸³⁵

b. Section 482 also applies to consolidated groups. Section 482 applies to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. tax return.⁸³⁶

2. Taxpayer's use of Section 482. If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely-filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Section 482 does not grant taxpayers any other right to apply, or to compel the application of, its provisions.⁸³⁷

⁸³²I.R.C. § 482.

⁸³³Treas. Reg. § 1.482-1(a)(1).

⁸³⁴Treas. Reg. § 1.482-1(a)(2).

⁸³⁵Treas. Reg. § 1.482-1(f)(1)(i).

⁸³⁶Treas. Reg. § 1.482-1(f)(1)(iv).

⁸³⁷Treas. Reg. § 1.482-1(a)(3).

D. Arm's length standard.

1. General rule. In determining the true taxable income of a controlled taxpayer, the IRS applies the "arm's length" standard. Under the arm's length standard, the IRS generally examines whether the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. An identical transaction is often difficult to locate. Thus, in determining whether a transaction produces an arm's length result, the IRS generally will examine whether the results of a controlled transaction are consistent with the results obtained in comparable transactions under comparable circumstances.⁸³⁸

2. Selection of method for testing whether a transaction meets the arm's length standard; best method rule. The methods of the IRS for determining whether a particular transaction meets the arm's length standard are set forth in Sections 1.482-2 through 1.482-6, 1.482-7 and 1.482-9 of the Regulations.⁸³⁹ Treas. Reg. § 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result. The IRS will generally use a method that results in the most reliable measure of an arm's length result.⁸⁴⁰ A detailed review of the difference pricing methods under Section 482 is beyond the scope of this outline.

⁸³⁸Treas. Reg. § 1.482-1(b)(1).

⁸³⁹Treas. Reg. § 1.482-1(b)(2).

⁸⁴⁰Treas. Reg. § 1.482-1(c)(1).

CHAPTER XXIII: SECTION 1059A

A. A U.S. taxpayer that imports property into the United States in a transaction from a person related to the taxpayer may not claim, for purposes of computing the basis or inventory cost of the property, a greater cost than the amount of the cost considered for customs valuation.⁸⁴¹ An item is not subject to this rule if the item is not subject to any customs duty or is subject to a free rate of duty.⁸⁴²

⁸⁴¹I.R.C. § 1059A(a).

⁸⁴²Treas. Reg. § 1.1059A-1(c)(1).

CHAPTER XXIV: EXCLUSION OF CERTAIN FOREIGN EARNED INCOME AND A HOUSING COST AMOUNT

Section 911 of the Code provides for the exclusion of certain foreign earned income and a housing cost amount from the gross income of certain U.S. persons for U.S. federal income tax purposes. An individual qualifies for the benefits of Section 911 if he meets (i) the physical presence test; or (ii) the bona fide foreign residence test.⁸⁴³

⁸⁴³I.R.C. § 911(d)(1).

CHAPTER XXV: ANTI-INVERSION RULES FOR CERTAIN EXPATRIATING ENTITIES

Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is a domestic corporation (or domestic partnership) with respect to which a foreign corporation is a surrogate foreign corporation, and any United States person related to such domestic corporation (or domestic partnership) (within the meaning of sections 267(b) or 707(b)(1)).⁸⁴⁴ A foreign corporation constitutes a surrogate foreign corporation if three conditions are satisfied:

1. The foreign corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation.⁸⁴⁵
2. After the acquisition at least 60 percent of the stock of the foreign corporation (by vote or value) is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (disregarding stock owned by members of the expanded affiliated group and stock sold in a public offering related to the acquisition⁸⁴⁶).⁸⁴⁷
3. After the acquisition the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group.⁸⁴⁸

Similar rules apply if a foreign corporation acquires substantially all the assets of a trade or business of a domestic partnership.

If the former shareholders of the acquired domestic corporation hold at least 60 percent, but less than 80 percent, of the stock of the foreign acquirer, the domestic corporation is required to include its inversion gain in its income for the year of the acquisition.⁸⁴⁹ The term "inversion gain" means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity, provided the transfer or license takes place as part of the domestic entity acquisition or, after the domestic entity acquisition if the transfer or license is to a foreign related person.⁸⁵⁰

⁸⁴⁴I.R.C. § 7874(a)(2)(A).

⁸⁴⁵I.R.C. § 7874(a)(2)(B)(i).

⁸⁴⁶I.R.C. § 7874(c)(2).

⁸⁴⁷I.R.C. § 7874(a)(2)(B)(ii).

⁸⁴⁸I.R.C. 7874(a)(2)(B)(iii).

⁸⁴⁹I.R.C. § 7874(a)(1).

⁸⁵⁰I.R.C. § 7874(d)(2).

Where the former shareholders of the domestic corporation receive 80 percent or more of the foreign acquiring corporation by reason of their ownership of the domestic corporation, the foreign acquiring corporation is treated as a domestic corporation for all purposes of the code.⁸⁵¹

Section 7874(c)(1) defines an expanded affiliated group as an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) shall be applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

⁸⁵¹I.R.C. § 7874(b).

CHAPTER XXVI: OFFSHORE VOLUNTARY DISCLOSURE

A. IRS Criminal Investigation Practice for Voluntary Disclosure. The Voluntary Disclosure Practice of the IRS Criminal Investigation Division (“CI”) is described in Section 9.5.11.9 of the Internal , Voluntary Disclosure Practice. Section 9.5.11.9(1) provides that “[i]t is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended.” This voluntary disclosure practice creates no substantive or procedural rights for taxpayers as it is simply a matter of internal IRS practice, provided solely for guidance to IRS personnel. Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution.⁸⁵²

A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with illegal source income.⁸⁵³

A voluntary disclosure occurs when the communication is truthful, timely, complete, and when: (1) a taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability; and (2) the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.⁸⁵⁴

A disclosure is timely if it is received before:

1. The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.
2. The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance.
3. The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.
4. The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).⁸⁵⁵

B. 2009 Offshore Voluntary Disclosure Program. In 2009, the IRS announced the 2009 Offshore Voluntary Disclosure Program (the “2009 OVDP”). The 2009 Offshore Voluntary Disclosure Program (2009 OVDP) was available to taxpayers beginning March 23, 2009, for voluntary disclosures received by the IRS through October 15, 2009. The objective of

⁸⁵²I.R.M. 9.5.11.9(1).

⁸⁵³I.R.M. 9.5.11.9(2).

⁸⁵⁴I.R.M. 9.5.11.9(3).

⁸⁵⁵I.R.M. 9.5.11.9(4).

the 2009 was “to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws.”⁸⁵⁶ The offshore penalty was a percentage of the amount in foreign bank accounts, or fair market value of assets, that was paid in lieu of other penalties during the six year look-back period. The IRS stated as follows with respect to the voluntary disclosure practice:

The Voluntary Disclosure Practice is a longstanding practice of IRS Criminal Investigation of taking timely, accurate, and complete voluntary disclosures into account in deciding whether to recommend to the Department of Justice that a taxpayer be criminally prosecuted. It enables noncompliant taxpayers to resolve their tax liabilities and minimize their chances of criminal prosecution. When a taxpayer truthfully, timely, and completely complies with all provisions of the voluntary disclosure practice, the IRS will not recommend criminal prosecution to the Department of Justice.⁸⁵⁷

C. 2011 Offshore Voluntary Disclosure Initiative. In 2011, the IRS announced the terms of a new Offshore Voluntary Disclosure Initiative (the “2011 OVDI”). The 2011 OVDI ran from February 8, 2011, for voluntary disclosures received by the IRS through September 9, 2011. The offshore penalty was a percentage of the amount in foreign bank accounts, or fair market value of assets, that were paid in lieu of other penalties during an eight year look-back period.

D. 2012 Offshore Voluntary Disclosure Program. On January 9, 2012, the IRS announced a new Offshore Voluntary Disclosure Program (the “2012 OVDP”). The 2012 OVDP was modified effective for submissions made on or after July 1, 2014. The modified program (“2014 OVDP”) will remain open until an expiration date is announced. The IRS has released frequently asked questions related to the 2014 OVDP (copy attached).

E. 2014 Streamlined Offshore Voluntary Disclosure Program. On June 18, 2014, the IRS announced streamlined filing compliance procedures. The streamlined filing compliance procedures are available to U.S. taxpayers residing in the United States who certify that their conduct was non-willful and pay a 5 percent miscellaneous offshore penalty. The IRS has released frequently asked questions related to the streamlined procedures (copy attached).

⁸⁵⁶2009 OVDP, Q&A No. 2.

⁸⁵⁷2009 OVDP, Q&A No. 4.

U.S. International Taxation

International Tax Symposium

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U.S. IMMIGRATION CONSIDERATIONS: OVERVIEW OF TYPES OF VISAS

Selected U.S. Nonimmigrant Visas

Purpose of Travel	Visa Category
Athlete, amateur or professional (competing for prize money only)	B-1
Au pair (exchange visitor)	J
Australian professional specialty	E-3
Border Crossing Card: Mexico	BCC
Business visitor	B-1
CNMI-only transitional worker	CW-1
Crewmember	D
Diplomat or foreign government official	A
Domestic employee or nanny - must be accompanying a foreign national employer	B-1
Employee of a designated international organization or NATO	G1-G5, NATO
Exchange visitor	J
Foreign military personnel stationed in the United States	A-2 NATO1-6
Foreign national with extraordinary ability in Sciences, Arts, Education, Business or Athletics	O
Free Trade Agreement (FTA) Professional: Chile, Singapore	H-1B1 – Chile H-1B1 – Singapore
International cultural exchange visitor	Q
Intra-company transferee	L
Medical treatment, visitor for	B-2

Source: <http://travel.state.gov/content/visas/english/general/all-visa-categories.html>

Purpose of Travel	Visa Category
Media, journalist	I
NAFTA professional worker: Mexico, Canada	TN/TD
Performing athlete, artist, entertainer	P
Physician	J, H-1B
Professor, scholar, teacher (exchange visitor)	J
Religious worker	R
Specialty occupations in fields requiring highly specialized knowledge	H-1B
Student: academic, vocational	F, M
Temporary agricultural worker	H-2A
Temporary worker performing other services or labor of a temporary or seasonal nature.	H-2B
Tourism, vacation, pleasure visitor	B-2
Training in a program not primarily for employment	H-3
Treaty trader/treaty investor	E
Transiting the United States	C
Victim of Criminal Activity	U
Victim of Human Trafficking	T
Nonimmigrant (V) Visa for Spouse and Children of a Lawful Permanent Resident (LPR)	V
Renewals in the U.S. - A, G, and NATO Visas	

Overview of Types of U.S. Immigrant Visas

Immediate Relative & Family Sponsored	Visa Category
Spouse of a U.S. Citizen	IR1, CR1
Spouse of a U.S. Citizen awaiting approval of an I-130 immigrant petition	K-3 *
Fiancé(e) to marry U.S. Citizen & live in U.S.	K-1 *
Intercountry Adoption of Orphan Children by U.S. Citizens	IR3, IH3, IR4, IH4
Certain Family Members of U.S. Citizens	IR2, CR2, IR5, F1, F3, F4
Certain Family Members of Lawful Permanent Residents	F2A, F2B
Employer Sponsored – Employment	Visa Category
Employment Based Immigrants, including (preference group):	
▪ Priority workers [First]	E1
▪ Professionals Holding Advanced Degrees and Persons of Exceptional Ability [Second]	E2

	Visa Category
▪ Professionals and Other Workers [Third]	E3, EW3
▪ Employment Creation/Investors [Fifth]	C5, T5, R5, I5
▪ Certain Special Immigrants: [Fourth]	S (many**)
Religious Workers	SD, SR
Iraqi and Afghan Translators/Interpreters	SI
Iraqis Who Worked for/on Behalf of the U.S. Government	SQ
Afghans Who Worked for/on Behalf of the U.S. Government	SQ
Other Immigrants	
Diversity Immigrant Visa	DV
Returning Resident	SB

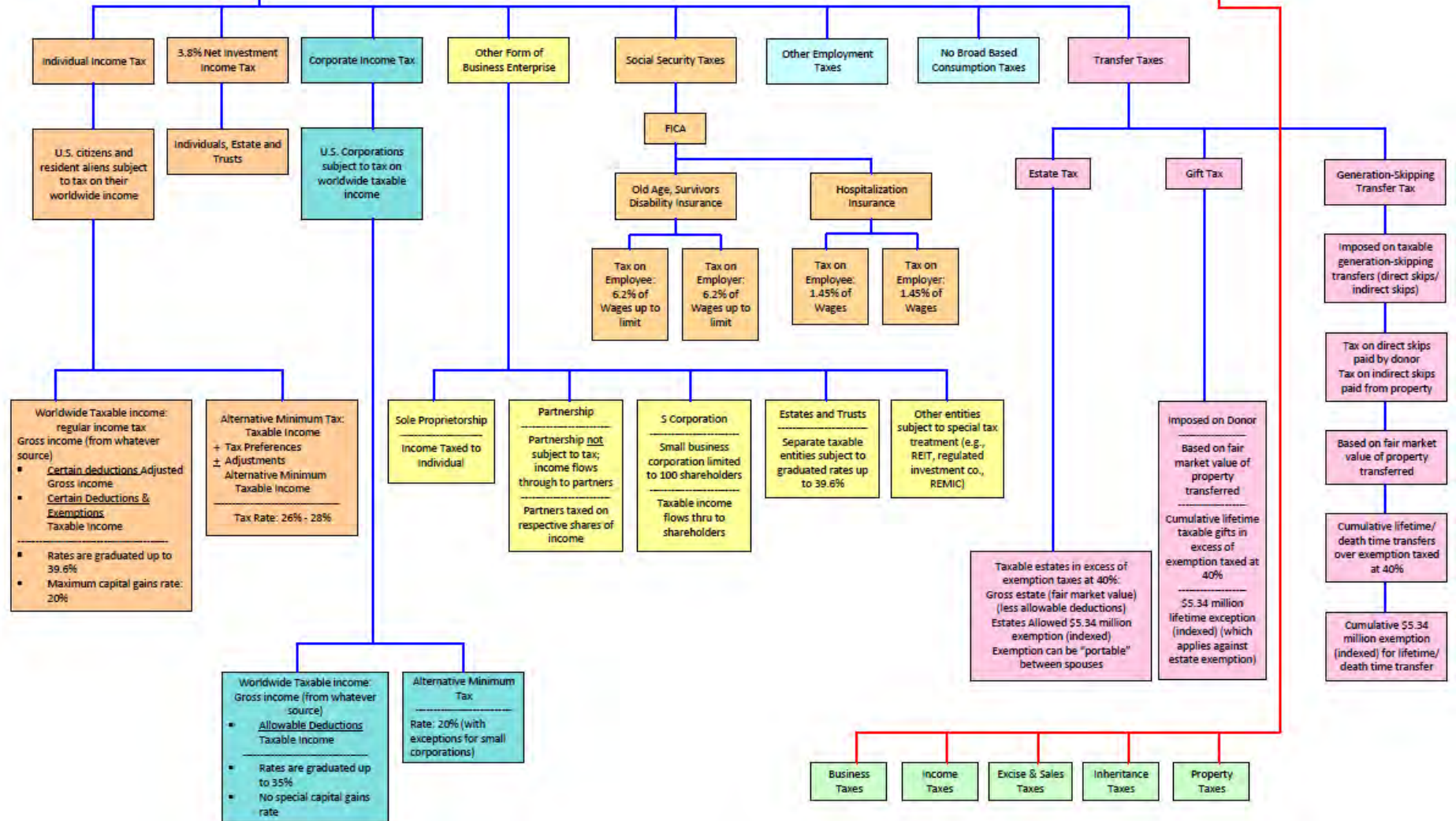
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OVERVIEW OF U.S. FEDERAL INCOME,
ESTATE AND GIFT TAX SYSTEM
APPLICABLE TO U.S. RESIDENT AND
NONRESIDENT ALIENS

TAXES OF THE UNITED STATES -- A GENERAL OVERVIEW OF U.S. DOMESTIC TAX LAW (2014)

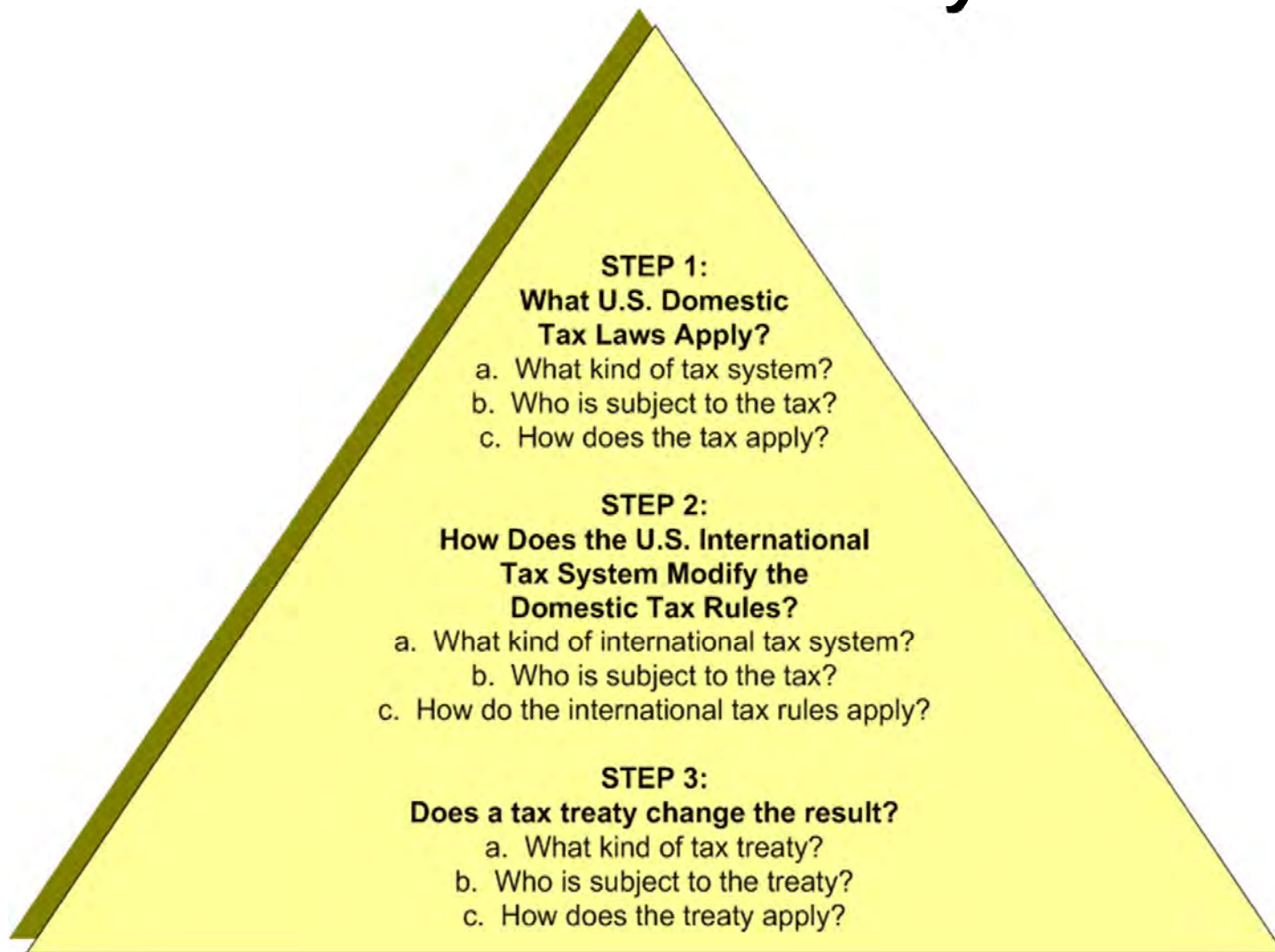
Taxes Imposed by the U.S. Government

Taxes Imposed by States and Local Government



SELECTED U.S. INTERNATIONAL TAX CONSIDERATIONS

International Tax Pyramid



Selected U.S. Federal Income Tax Considerations

1. Taxation of Nonresident Aliens and Foreign Corporations.

- a. **Trade or Business Income:** Nonresident aliens and foreign corporations are subject to U.S. federal income taxation on their taxable income that is effectively connected with the conduct of a U.S. trade or business.
- b. **Investment Income:** The U.S. also imposes a 30% tax (or such lesser rate as is provided by an applicable income tax treaty) on the gross amount of U.S. source interest, dividends, rents, royalties and other fixed, determinable, annual or periodical income from U.S. sources of nonresident aliens and foreign corporations if such income is not effectively connected with the conduct of a U.S. trade or business.
- c. **U.S. Branch Profits Tax.** In addition, foreign corporations doing business in the U.S. are subject to the branch profits tax.
- d. **U.S. Income Tax Treaties.** U.S. income tax treaties often modify the general rules of taxation for nonresident aliens and foreign corporations doing business or investing in the U.S. An applicable income tax treaty may reduce or eliminate the 30% gross-basis tax imposed on nonresident aliens and foreign corporations. In addition, an applicable income tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment.

2. U.S. Citizens, Resident Aliens and U.S. Corporations.

- a. Taxation on Worldwide Income.** U.S. citizens, resident aliens and U.S. corporations are generally subject to U.S. income taxation on their worldwide income.
- b. Foreign Tax Credit.** To avoid double taxation of income earned abroad, the U.S. allows a credit for income taxes paid to foreign countries with respect to foreign source income. The U.S. also allows certain U.S. corporate shareholders in foreign corporations to claim a credit (known as the indirect or deemed-paid credit), generally in the year the foreign corporation pays a dividend, for foreign income taxes paid by the foreign corporation.

3. Residency for U.S. Federal Income Tax Purposes.

a. Tests for Residency:

1) Greencard Test.

- 2) Substantial Presence Test.
 - a) Formula-Based Test:
 - i. 31 days in the current year; AND
 - ii. Sum of the following $\geq$ 183 days:
 - A. Days in the current year, plus
 - B. 1/3 of days in 1st preceding year, plus
 - C. 1/6 of days in second preceding year
 - b) Closer Connection Exception – Form 8840
 - c) Tax Treaties.

b. First Year of Residency Considerations.

SELECTED TAX TREATY CONSIDERATIONS

SELECTED TAX TREATY CONSIDERATIONS

- A. Functions of Tax Treaties
- B. Persons Covered
- C. Issues Covered
- D. Other Matters Often Covered in Income Tax Treaties
- E. Disclosure Requirement
- F. Relationship of Treaties to Internal U.S. Law
 - 1. How are Treaties Adopted?
 - 2. U.S. Constitution
 - 3. Provisions of Internal Revenue Code Affecting Interrelationship between Treaties and Internal U.S. Law

Expatriation Legislation Considerations

- A. General Operation of Section 877A and Section 2801
- B. Property Subject to the Deemed Sale Rules of Section 877A
- C. Application of Section 877A

U.S. Federal Estate and Gift Tax Considerations

1. **Nonresident Aliens.** For U.S. federal estate and gift tax purposes, nonresident aliens are subject to U.S. federal estate and gift tax on their “property situated in the U.S.”
2. **Estate Tax Treaties.** U.S. estate tax treaties may affect the determination of whether an alien is domiciled in the U.S. for U.S. estate tax purposes.
3. **Residency for U.S. Estate and Gift Tax Purposes.**
 - a. The residency test for federal estate and gift tax purposes is different than the residency test for federal income tax purposes. An individual may be a “resident” for income tax purposes but not for estate and gift tax purposes.
 - b. For U.S. estate and gift tax purposes, a U.S. resident is an individual who was domiciled in the U.S. at the time of his death or gift, whichever is applicable.
 - c. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving.
 - d. Residence without the requisite present intention to remain indefinitely will not sufficiently constitute a domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

- A. Overview of U.S. Estate Tax Rules Applicable to Nonresident Aliens
 - 1. Determining the Gross Estate
 - a. Property Situated in the U.S.
 - b. Property Not Situated in the U.S
 - 2. Estate Tax Rates
 - 3. Estate Tax Credit
- B. Overview of U.S. Gift Tax Rules Applicable to Nonresident Aliens
- C. U.S. Estate and Gift Tax Treaties

SOURCES OF INCOME

A. Interest.

1. U.S.-Source Interest
2. Foreign-Source Interest

B. Dividends.

1. U.S.-Source Dividends.

- a. General Rule

- b. Qualifying Foreign Corporation

2. Foreign-Source Dividends

C. Personal Service Income.

1. U.S.-Source Income
2. Foreign-Source Income
3. Services Performed Partly Within and Partly Without the U.S.

D. Rents and Royalties.

1. U.S.-Source Income
2. Foreign-Source Income

E. Real Estate Sales.

1. U.S.-Source Income
2. Foreign-Source Income

U.S. TRADE OR BUSINESS STATUS OF A NONRESIDENT ALIEN IN THE UNITED STATES

- A. What Is the Significance of a Nonresident Alien Engaging in a U.S. Trade or Business?
- B. How Is “Trade or Business” Status Determined?
 - 1. Relevant Factors in Determining Trade or Business Status
 - 2. Activities of Agent Attributed to Nonresident Alien or Foreign Corporation
 - 3. Trade or Business Includes Performance of Personal Services in the U.S.
 - 4. Special Rules Apply to Trading in Stocks or Securities

- A. General Pattern of Taxation of U.S. Trade or Business Income of Foreign Persons
- B. Taxation of U.S. Capital Gain Income
- C. Branch Profits Tax Applies to Foreign Corporations Doing Business in the U.S
- D. Special Withholding Rules Applicable to Partnership Effectively Connected Income.
 - 1. Withholding on Partnership Effectively Connected Taxable Income
 - 2. Determining Effectively-Connected Taxable Income
 - 3. Service Issues Regulations Addressing Withholding Rules Applicable to Partnership Effectively Connected Income
- E. Income Tax Treaties May Modify the General Rules of Taxation
- F. Selected U.S. Reporting Issues

U.S. INCOME TAXATION OF U.S.
SOURCE INVESTMENT INCOME OF A
NONRESIDENT ALIEN

- A. Taxation of Effectively Connected Fixed Determinable, Annual or Periodical Income
- B. Taxation of Non-Effectively Connected FDAP Income

**SPECIAL TAX CONSIDERATIONS
PERTAINING TO OWNERSHIP AND
DISPOSITION OF U.S. REAL ESTATE
BY FOREIGN PERSONS**

U.S. INCOME TAXATION OF U.S.
SOURCE INVESTMENT INCOME OF A
NONRESIDENT ALIEN

SELECTED U.S. PAYROLL TAX ISSUES RELATING TO NONRESIDENT ALIENS

A. FICA.

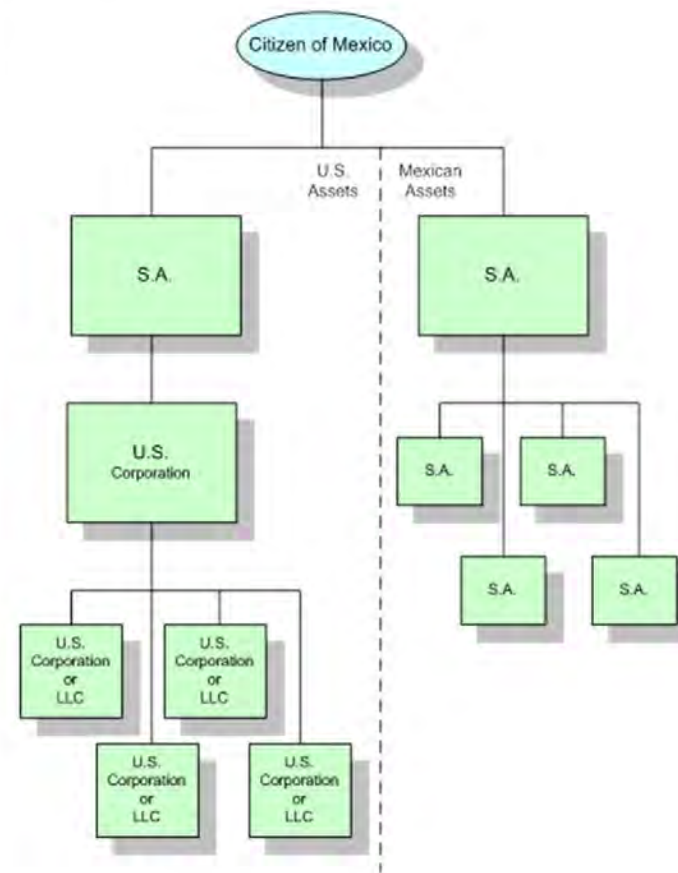
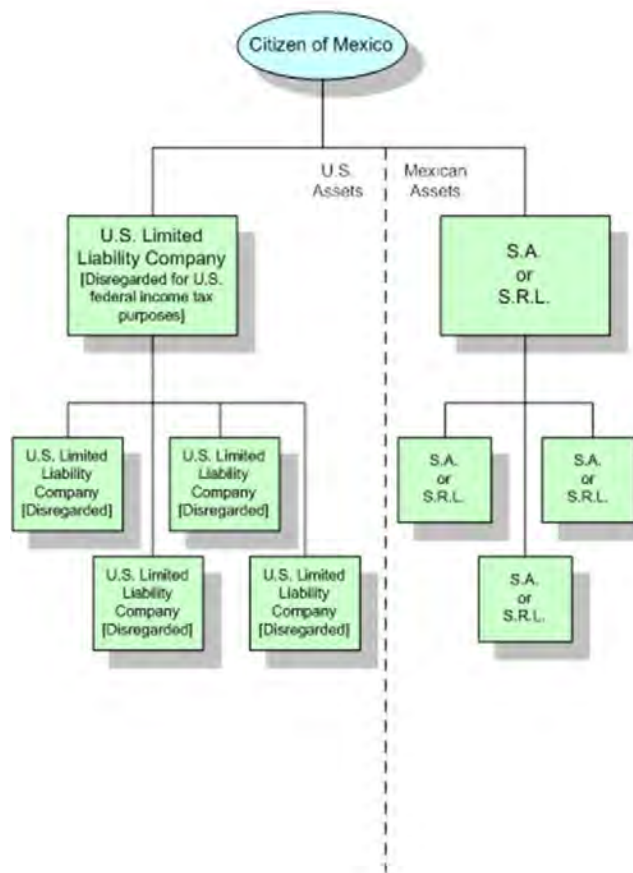
1. General Statutory Authority for FICA Tax Liabilities
2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.
 - a. Wages Paid by U.S. Person/Employer
 - b. Wages Paid by Foreign Person/Employer
3. Exception to Liability for Persons in Certain Visa Categories
4. Impact of Totalization Agreements

B. FUTA.

1. General Statutory Authority for FUTA Tax Liability
2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.
 - a. Wages Paid by U.S. Person/Employer
 - b. Wages Paid by Foreign Person/Employer
3. Exceptions to Liability for Persons in Certain Visa Categories

C. Self-Employment Tax.

Illustration of Structuring Issues for Citizens of Mexico



S.A. = Sociedad Anonima
S.R.L. = Sociedad de Responsabilidad Limitada

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Taxes Eligible for the Foreign Tax Credit

Ben Vesely
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2016 International Tax Symposium
Dallas (November 3rd) & Houston (November 4th)



DISCLOSURE: IMPORTANT – PLEASE NOTE

- The following presentation is intended for educational and discussion purposes only and cannot be relied upon as tax or accounting advice.
- You should seek advice from a qualified advisor based on your specific facts and circumstances before taking any action.
- The matters discussed during this presentation do not necessarily reflect BDO USA, LLP policy.
- BDO USA, LLP will not be responsible for any loss that results from reliance on this presentation.



Agenda

- Foreign tax credit basics
- Creditability basics
- Practical issues
- Recent Developments

FOREIGN TAX CREDIT BASICS



Foreign Tax Credit Basics

Purpose of the FTC is to mitigate double taxation

Basic FTC Provisions:

- Section 901, 902, 960 – direct and indirect
- Section 903 – in lieu of
- Section 904 – the limitation
- Section 861 – the sourcing
- Section 905 – the timing



Foreign Tax Credit Basics

Creditability:

- Section 901(b) – “any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States”
- Reg. 1.901-2
 - Predominant character of that tax is that of an income tax in the U.S. sense
 - “net gain”– must meet all 3 requirements to be a tax likely to reach “net gain”
 - Realization
 - Gross receipts
 - Net income
 - Must be compulsory



Foreign Tax Credit Basics

Creditability - Net Gain:

- Realization test - Reg. 1.901-2(b)(2) – Tax generally imposed upon or subsequent to the occurrence of events that would result in realization of income under the IRC
- Gross receipts test – Reg. 1.901-2(b)(3) – Tax imposed on basis of gross receipts or on the basis of gross receipts that produces an amount that is not greater than FMV of gross receipts
- Net income test – Reg. 1.901-2(b)(4) – Tax base must be computed by reducing gross receipts in a manner that permits either
 - Recovery of significant costs and expenses attributable to such gross receipts, or
 - Recovery of such costs and expenses computed using a method that is likely to produce an amount that approximates or is greater than recovery of such costs and expenses



Foreign Tax Credit Basics

Creditability – Net Income:

- Reg. 1.901-2(b)(4)(i) – “A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).”



Timing of the Credit: Section 905

Generally

- When “paid or accrued.” Dependent on taxpayer’s accounting method
 - Accrual: “all events” test → (1) all events have happened to fix the fact of liability and (2) amount is determinable with reasonable certainty
 - Cash: when paid. May elect to claim when accrued.

Re-determinations 905(c)

- A change in the foreign tax liability that may affect a taxpayer’s foreign tax credit (Treas. Reg. §1.905-3T(c)). This includes:
 - (1) actual payments of tax that differ from the amount accrued, accrued taxes not paid within 2 yrs of the close of the TY to which they relate, and refunded taxes.
 - (2) difference between dollar value of tax accrued and tax paid due to currency fluctuations
- Compliance: notify the Service pursuant to Treas. Reg. §1.905-4T.



Foreign Tax Credit Basics

Is my foreign tax creditable?

- Does it meet the definition of an income tax under Reg. 1.901-2 or Section 903 and meet the timing requirements of Section 905?
- Is US taxpayer treated as having actually paid this tax under Sections 901, 902 and 960?
- Does US taxpayer have sufficient foreign sourced income to be able to actually use the credit?

PRACTICAL ISSUES



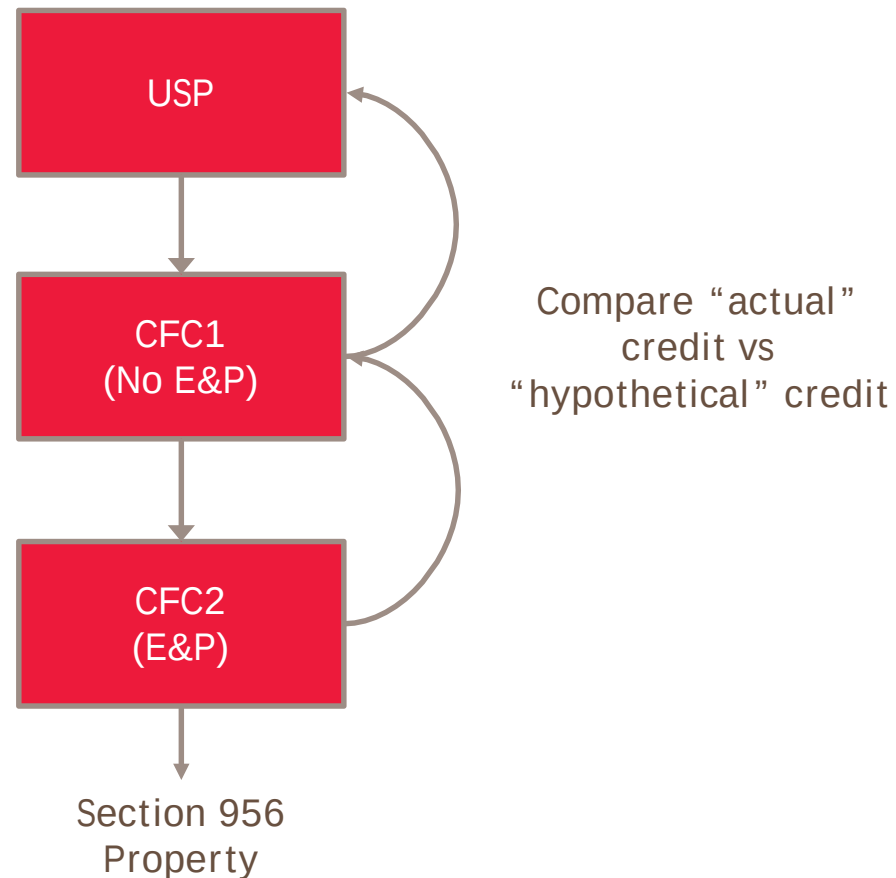
Foreign Tax Credit Basics

Is my foreign tax creditable?

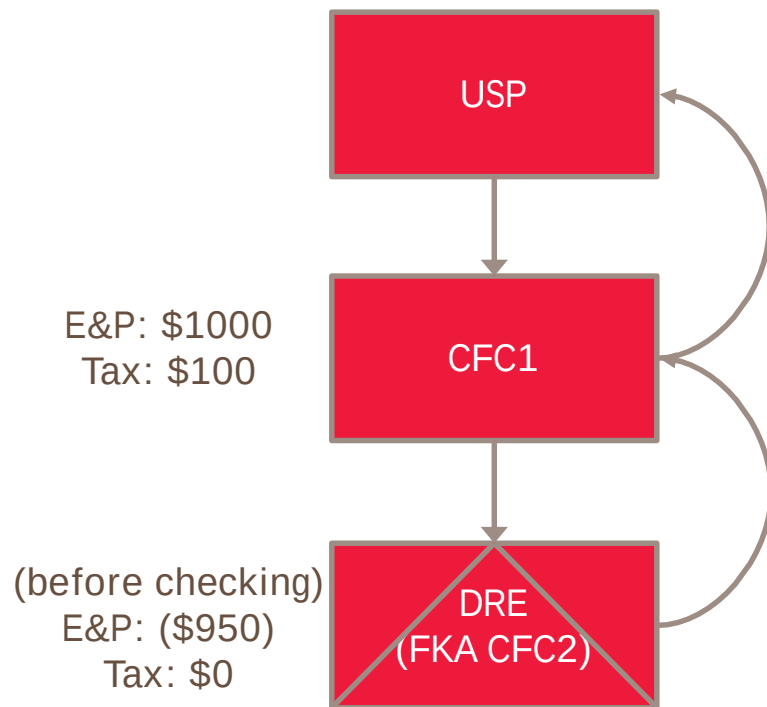
Consider:

- Section 861 – sourcing rules
- Section 960(c) – anti-hopscotch rule
- Reg. 1.367(b)-7 – Hovering deficit
- Foreign tax credit splitter rules (section 909)
- Reg. 1.960-1(i) and 1.954-1(f)(4) – the buckets
- Tax treaty re-sourcing provisions
- Section 901(m)
- CCA 201349015

Section 960(c) – Anti-Hopscotch Rule



Reg. 1.367(b)-7 – Hovering Deficit Rule



Background

- DRE elects to be disregarded 1/1/15
- CFC1 makes distribution of \$50 to USP on 1/1/16
- Assume no other activity

Result

- Former CFC2's deficit 'hovers' and does not offset CFC1's E&P so only \$5 of taxes comes up with distribution ($\$50/\$1000 \times \$100$)



Section 909 – FTC Splitter

Splitting Event: the income to which the foreign tax relates is, or will be, taken into account by a covered person. FTC is suspended until the corresponding income is recognized by a U.S. person or a CFC. IRC §909(a)

If there is a FTC splitting event:

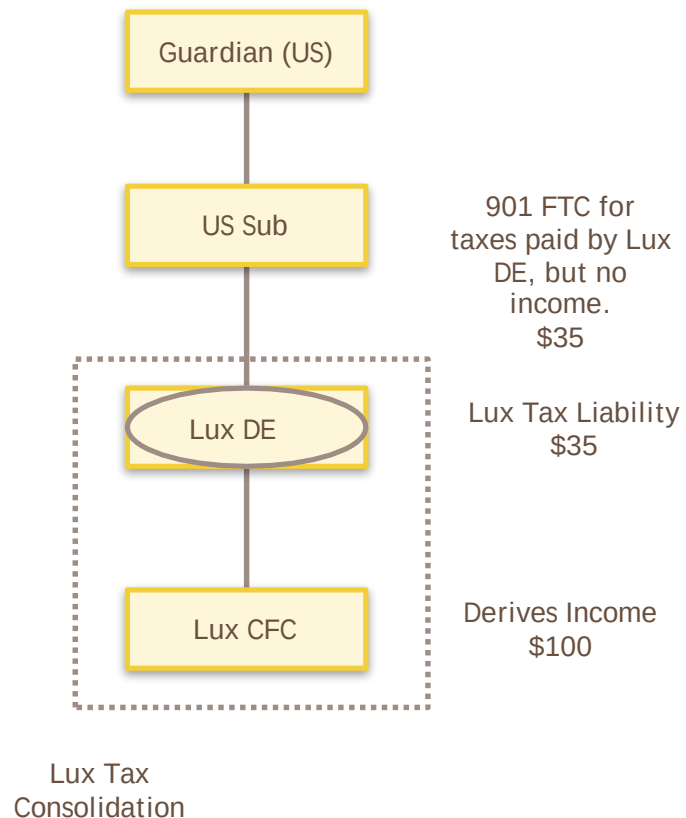
- §901 taxes – suspended until US shareholder recognizes the income
- §902/960 taxes – suspended until the CFC that accrued the foreign taxes recognizes the income or the US shareholder recognizes the income
- Deductions for taxes is also deferred (including for E&P purposes)

4 common splitter transactions/arrangements

- Reverse Hybrid
- Loss-sharing
- Hybrid instrument
- Partnership inter-branch payment

Section 909 Background:

Guardian Industries



Facts

Guardian was not required to include Lux group earnings on its U.S. return

Arguments

- (1) Guardian: technical tax payer rule allows for FTC
- (2) Service: No FTC because Guardian was a mere collection agent under Lux law and divorced the FTC from the subs that earned the income.

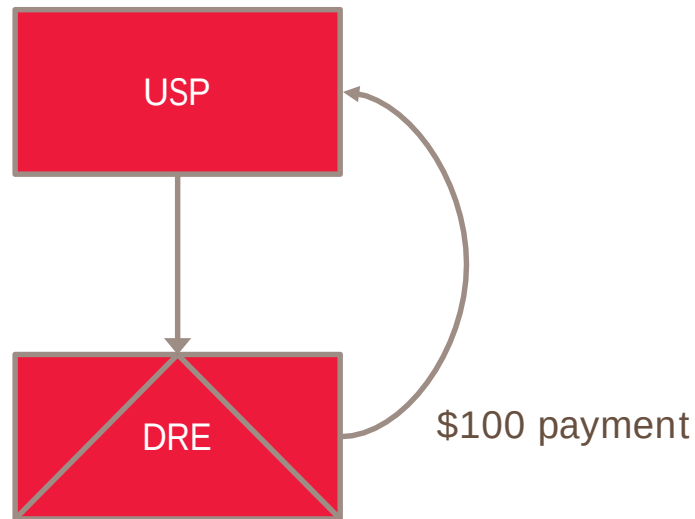
Held

Guardian was entitled to the credit

Policy Result

Congress enacted IRC Section 909 to prevent this result moving forward

CCA 201349015



Question

- Does section 482 apply to this payment?

CCA 201349015

- The amount of the payment can be treated as a 'remittance' under Section 987
- IRS acknowledges that while 482 adjustments to the payment may not affect USP's worldwide taxable income, transfer pricing would have relevance in the local jurisdiction in determining taxable income
- Reg. 1.901-2(e)(5) - non-compulsory payment rule
- Section 905(b) - substantiation
- This payment is subject to 482 on the premise that it can impact the amount of foreign taxes paid
- Same rule can apply to a CFC with a DRE (902/960)

RECENT DEVELOPMENTS



Notice 2016-52

- Issued September 15, 2016 – announces intention to release regulations under Section 909 (FTC splitters) to address situations in which splitter situations could arise where there are foreign-initiated adjustments to which 905(c) would apply
- Adjustments due to the EU state aid rules are specifically identified as ones which may be subject to these rules, but reserves that other situations may be applicable as well

Targeted examples:

- Example 1 – Foreign DRE is transferred from CFC1 to CFC2 in year 6 in a 351 transaction and in year 8 an assessment against DRE is levied for years 1 to 5
- Example 2 – CFC2 makes distribution to CFC1 in year 11, in year 12 foreign income tax is levied on CFC2 for years 1 through 9
- Example 3 – Same as example 2 except CFC1 also makes a distribution in year 11 to CFC3



Indirect Stock Transfer Tax - China

- Public Notice 7 – indirect equity transfer of offshore holding company gives rise to capital gains tax on arrangements made without any “reasonable commercial purpose.”
- Targets offshore transfers where significant value is derived from Chinese business and transfers without substance
- Some safe harbors exist
- Transferor should assess whether a reasonable commercial purpose exists. If inconclusive, then it may present the case to the Chinese tax authorities for a determination within 30 days of signing the transfer contract.



Indirect Stock Transfer Tax - India

- Gains arising from the transfer of shares of a foreign entity (FE) is taxable in India if the FE's share derive their value substantially from assets located in India
 - Amendment to Finance Act 2012 following *Vodafone Case*
 - Capital gains will be taxed on proportionate basis in India
- Substantiality
 - Value of Indian assets exceeds INR100MM, and
 - Gross FMV of assets located in India comprise 50% of FMV of total assets of the entity
- Indian entity must report information of the transfer. Otherwise:
 - A 2% penalty of the value of the transfer if such transfer directly or indirectly modified the ownership structure or control of the Indian entity,
 - INR0.5MM in any other case



Non-Resident Capital Gains Tax

- Brazil and India both assess a capital gains tax on non-residents transferring shares of Brazilian and Indian companies (respectively)
- Is this tax creditable in the US?
 - Sourcing of sale of shares in a foreign company? Generally is residence of the seller
 - What if Section 1248 applies? What if there is no E&P?

UK Diverted Profits Tax (“DPT”)

- ▶ DPT is designed to counter aggressive planning techniques used by multinational companies for diversion of profits from the U.K.
- ▶ 25 % rate of tax – NOT corporation tax
- ▶ Effective April 1, 2015
- ▶ Potentially caught:
 - Avoidance of a U.K. permanent establishment (“PE”)
 - Exploitation of tax mismatches through the use of arrangements or entities lacking economic substance by either a:
 - o U.K. company; or
 - o U.K. PE



Equalization Levy - India

- India's reaction to tax challenges of evolving digital economy
- Scope of Levy
 - On non-resident not having PE in India
 - Charge of 6% on consideration for 'specified services' received from person resident in India carrying on business in India or non-resident with a PE in India
- Specified Services
 - Digital space, facility or service for online advertisements
 - May be expanded later
- Exclusion where payments do not exceed 100k INR (about \$1,500 USD)
- Collection
 - Payer has obligation to deduct and pay levy
 - Even if not deducted – still responsible to pay
- Penalty
 - Interest and penalty for non-compliance
 - Possible disallowance of expenditure

BIOGRAPHY



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EXPERIENCE SUMMARY

Ben has worked with BDO for over 8 years focusing on international tax planning, consulting and compliance within BDO's International Tax Services Group. Ben has advised extensively on international tax matters, including structuring inbound and outbound investments for clients as well as providing international tax support for mergers and acquisitions activity and tax due diligence projects. He has experience in many different areas of international taxation including cross-border financing, tax considerations of global expansion, supply chain planning and repatriation planning.

Ben has been involved in numerous large international tax compliance engagements and has assisted many clients in their international restructuring projects focusing on creating and maintaining practical tax efficient structures for multinational companies. He has worked extensively with clients from many different industries - including Technology, Manufacturing & Distribution as well as Private Equity clients.

Ben is a member of BDO's UK-US Tax Desk focusing on cross-border tax issues that specifically arise between the US and UK. Ben is also a member of BDO's specialty groups relating to the Foreign Account Tax Compliance Act ("FATCA") and Interest Charge Domestic International Sales Corporations ("IC-DISCs").

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State Bar of Texas, Tax Section; Chair, International Tax Committee; Chair, Annual Meeting Committee
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EDUCATION

LLM in Taxation, Northwestern University School of Law
JD, Southern Methodist University



Questions?

International Estate Planning Update

Prepared and Presented by

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Transfer Tax Residents

- * Transfer Taxes are imposed on U.S. citizens and residents
- * Residents are those who are domiciled and primarily residing in the U.S.A. with no definite present intention of leaving, regardless of the time actually present. Treas. Reg. §§ 20.0-1(b), 25.2501-1(b).
- * Not a bright-line rule like the Substantial Presence Test, but a facts-and-circumstances test
- * All others are considered a “nonresident not a citizen of the United States”

U.S. Estate Taxation of Nonresidents

- * Estate Tax applied to property located in the U.S.A.
 - * Stock in U.S. corporations (whether or not publicly traded)
 - * Real property in the U.S.A.
 - * Tangible property in the U.S.A. (e.g., cash in a safe deposit box)
 - * Uncertain treatment of foreign partnership interests
 - * Revocable trusts
 - * \$60,000 estate tax exemption (not adjusted for inflation)
 - * Nonrecourse debt on U.S. property results in only net value included in U.S. estate

U.S. Estate Taxation of Nonresidents

- * Unlimited marital deduction is available for assets left to U.S.-citizen spouses.
 - * A “QDOT” can be established for non-citizen spouses
- * Deductions available for charitable contributions and estate administration expenses
 - * The deduction is based on a ratio of U.S. assets to worldwide assets
- * Donees take stepped-up basis in transferred property
- * DSUE is not available for nonresident non-citizens.

U.S. Gift Taxation of Nonresidents

- * Gift Tax applied to property located in the U.S.A.
 - * Real property in the U.S.A.
 - * Tangible property in the U.S.A. (e.g., cash in a safe deposit box)

U.S. Gift Taxation of Nonresidents

- * No lifetime exemption
- * \$14,000 Annual Exclusion for gifts to non-spouses
- * \$148,000 Annual Exclusion for gifts to non-citizen spouses in 2016, and \$149,000 in 2017
- * Unlimited marital deduction for gifts to citizen spouses
- * Unlimited exclusions for educational and medical payments
- * Donees take a carryover basis in transferred property
- * The GST Tax applies if the Estate or Gift Taxes apply
 - * \$1,000,000 GST exemption(?)

U.S. Estate & Gift Tax Treaties

Corporations

Partnerships

International Businesses

Small Businesses & Self-Employed

Small Business/Self-Employed Topics

- A-Z Index for Business
- EINs
- Forms & Pubs
- Industries/Professions
- Online Learning
- Operating a Business
- Self-Employed
- Starting a Business

Estate & Gift Tax Treaties (International)



Related Topics

› Estate and Gift Taxes

Country	Separate Estate	Separate Gift	Combined E & G	Other	Signed	Transfers made on or after:	Comments
Australia	No	Yes	No	No	5305	12/14/53	PR-UC
Australia	Yes	No	No	No	5305	01/07/54	old * PR-UC
Austria	No	No	Yes	No	8206	07/01/83	new *
Belgium	Yes	No	No	No	5405	not yet	old no effect
Canada	No	No	No	1995 Protocol	9503	11/09/95 **	estate tax only PR-UC
Denmark	No	No	Yes	No	8304	11/07/84	new
Finland	Yes	No	No	No	5203	12/18/52	old PR-UC
France	No	No	Yes	No	7811	10/01/80	new PR-UC (Protocol)
Germany	No	No	Yes	No	8012	01/01/79	new PR-UC (Protocol)
Greece	Yes	No	No	No	5002	12/30/53	old PR-UC
Ireland	Yes	No	No	No	4909	12/20/51	old
Italy	Yes	No	No	No	5503	10/26/56	old PR-UC
Japan	No	No	Yes	No	5404	04/01/55	old PR-UC
Netherlands	Yes	No	No	No	6907	02/03/71	new
Norway	Yes	No	No	No	4906	12/11/51	old PR-UC
South Africa	Yes	No	No	No	4704	07/15/52	old
Sweden	No	No	Yes	No	8306	09/05/84 (through 12/31/07)	new (terminated 01/01/08)
Switzerland	Yes	No	No	No	5107	09/17/52	old PR-UC
U.K.	No	No	Yes	No	7810	11/11/79	new

* old or new refers to whether the treaty has the "old" situs rules, or the "new" provisions that generally restrict the U.S. to taxing nonresident aliens' U.S. real estate and business property.

** the 1995 Protocol had retroactive effect to TAMRA. Claims for refund based upon the treaty had to be filed by 11/09/96.

"PR-UC" in comments section above refers to a pro-rata unified credit provision. (The pro-rata unified credit provisions in the German and French treaties apply only to estate tax, not to gift tax.)

[Rate the Small Business and Self-Employed Website](#)

Page Last Reviewed or Updated: 04-May-2016

Available at <http://ow.ly/TLGKH>

Estate & Gift Tax Treaties

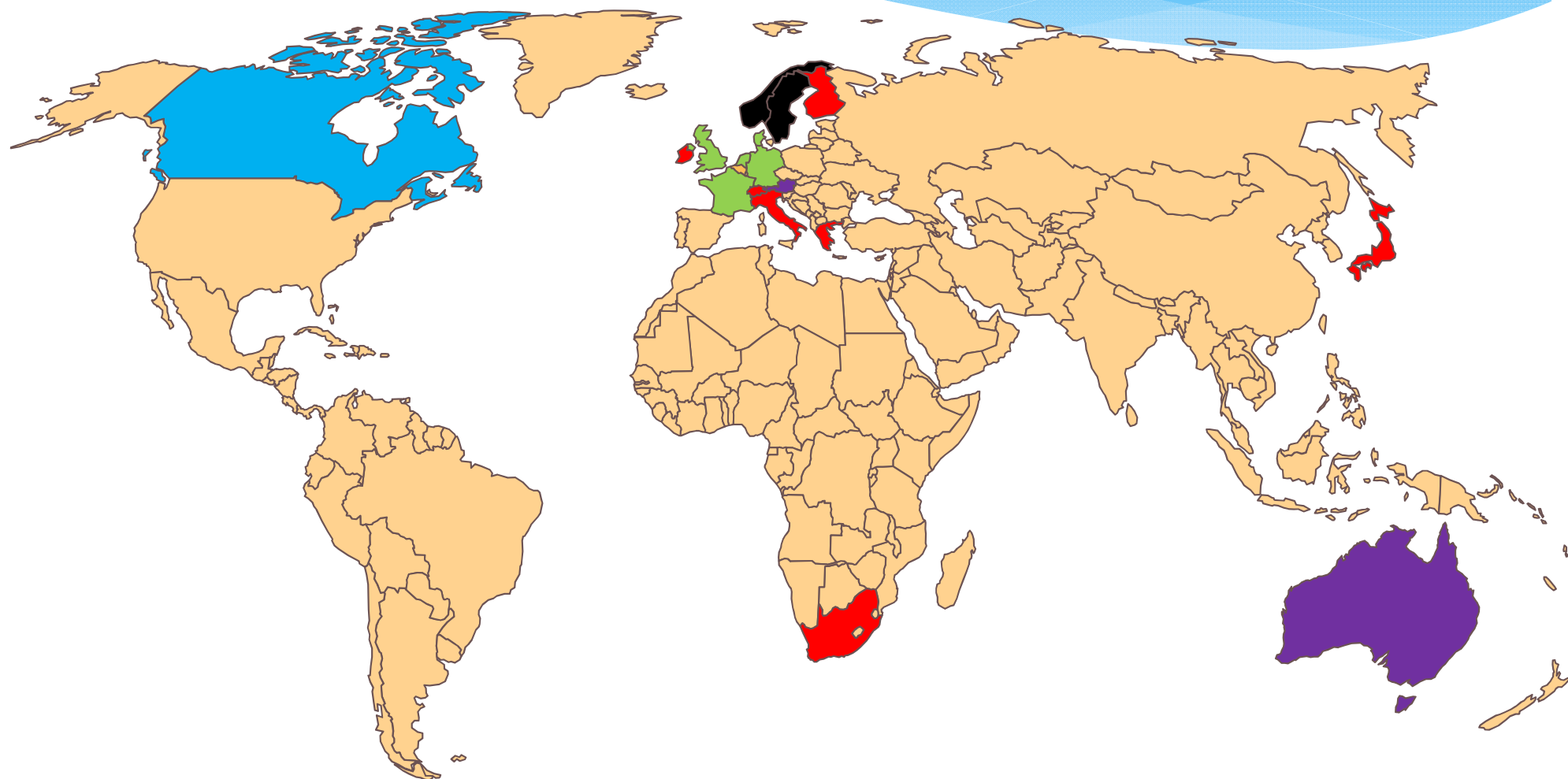
* 7 Situs-Type Treaties

- * Allocation taxation of assets to jurisdictions based on the situs of the assets.
- * Treaties with ~~Australia~~, Finland, Greece, Ireland, Italy, Japan, ~~Norway~~, South Africa, & Switzerland.

* 6 Domicile-Type Treaties

- * Allocate taxation of assets to jurisdictions based on the domicile of the taxpayer.
- * Treaties with ~~Austria~~, Denmark, France, Germany, Netherlands, ~~Sweden~~, & the United Kingdom.
- * Protocol Amending United States-Canada Income Tax Treaty.

U.S. Estate & Gift Tax Treaty Partners



Form 8971

- * An executor of an estate who must file Form 706 or Form 706-NA must *also* file Form 8971 with attached Schedule A and to provide each beneficiary listed on the Form 8971 with that beneficiary's Schedule A.
- * The executor must include the beneficiary's Social Security Number (SSN), an Employer Identification Number (EIN), an Individual Taxpayer Identification Number (ITIN).
- * *But what if the beneficiary does not already have a TIN?*

Form 8938

- * Beginning in tax year 2016, “specified domestic entities” must comply with the Form 8938 reporting requirement.
- * A domestic corporation is a “specified domestic entity” if that corporation is “formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets.” This determination is made annually. Treas. Reg. § 1.6308D-6(a).

Form 8938

- * A domestic corporation will be considered “formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets” if both of the following are true.
 - * The corporation is “closely held” by a “specified individual” under Treas. Reg. § 1.6308D-6(b)(2).
 - * For the taxable year in question, either at least 50% of the corporation's gross income is passive income, or at least 50% of the assets held by the corporation are assets that produce or are held for the production of passive income. Treas. Reg. § 1.6308D-6(b)(1).

Form 8938

- * A “specified individual” includes U.S. citizens. Treas. Reg. § 1.6308D-1(a)(2)(i)-(ii).
- * A domestic corporation is “closely held” if a specified individual owns, directly, indirectly, or constructively, on the last day of the corporation’s taxable year either at least 80% of the total combined voting power of all classes of stock of the corporation entitled to vote, or at least 80% of the total value of the stock of the corporation. Treas. Reg. § 1.6308D-6(b)(2)(i).

Form 5472

- * Form 5472 is used to report information required under Code § 6038A and Code § 6038C when reportable transactions occur during the tax year of a reporting corporation with a foreign or domestic related party.

- * **Reporting corporation.** A reporting corporation is either:
 - * A 25% foreign-owned U.S. corporation, or
 - * A foreign corporation engaged in a trade or business within the United States.
- * **25% foreign-owned.** A corporation is 25% foreign owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year.
- * **25% foreign shareholder.** A foreign person is a 25% foreign shareholder if the person owns, directly or indirectly, at least 25% of either:
 - * The total voting power of all classes of stock entitled to vote, or
 - * The total value of all classes of stock of the corporation.

- * **Reporting corporation.** A reporting corporation is either:
 - * A 25% foreign-owned U.S. corporation, or
 - * A foreign corporation engaged in a trade or business within the United States.
- * **25% foreign-owned.** A corporation is 25% foreign owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year.
- * **25% foreign shareholder.** A foreign person is a 25% foreign shareholder if the person owns, directly or indirectly, at least 25% of either:
 - * The total voting power of all classes of stock entitled to vote, or
 - * The total value of all classes of stock of the corporation.

Code § 877A Expatriation

- * U.S. citizens and long-term U.S. residents who cease to be permanent U.S. residents may be “Covered Expatriates.”
- * Three-prong test to not be a Covered Expatriate
 - * Average annual net income tax bill for the five prior years ending before expatriation under \$161,000 in 2016 (adjusted for inflation)
 - * Net worth under \$2,000,000 on date of expatriation (not adjusted for inflation)
 - * Certify on Form 8854 that you’ve complied with all U.S. federal tax filing obligations for 5 years preceding date of expatriation
- * Income tax on mark-to-market valuation of assets on the day before expatriation (\$693,000 exemption in 2016, \$699,000 in 2017)
- * Must report for 10 years.
- * *Topsnik v. Comm’r.*, 143 T.C. No. 12 (2014).
 - * If you fail to properly surrender your Green Card, then you haven’t left the U.S. tax system.

Form 708

- * Code § 2801 imposes a 40% inheritance-style tax on transfers from Covered Expatriates to Estate & Gift Tax Residents.
- * The annual exclusion applies, but the medical and education exemptions don't apply.
- * The tax is not imposed if the transferor files Form 706 or 709.
- * This will not be imposed until the Treasury Regulations have been finalized.
- * Example: \$50,000 gift for tuition paid directly to the institution
 - * After the \$14,000 annual exclusion, \$36,000 remains subject to tax.
 - * $40\% \times \$36,000 = \$14,400$ tax that Billy, not the transferor, must pay.

Income Tax Treaty System

- * The U.S.A. is a party to 58 bilateral income tax treaties with 68 countries.
 - * The U.S.–U.S.S.R. income tax treaty remains in effect for members of the Commonwealth of Independent States that have not negotiated and ratified new treaties.
 - * The U.S.–China income tax treaty does not apply to Hong Kong.
- * Three additional treaties (Chile, Hungary, & Poland) and four protocols (Japan, Luxembourg, Spain, & Switzerland) have been signed but not approved by the Senate.

Income Tax Treaties

The screenshot shows the IRS website's navigation bar with links for Filing, Payments, Refunds, Credits & Deductions, News & Events, Forms & Pubs, Help & Resources, and for Tax Pros. A search bar is located on the right. The left sidebar contains a menu with 'Corporations', 'Partnerships', 'International Businesses' (highlighted), and 'Small Businesses & Self-Employed'. Under 'International Businesses', there is a 'Topics' section with links to 'Individual Taxpayer', 'Income Tax Treaties', 'KYC Rules', and 'International Businesses Home'.

United States Income Tax Treaties - A to Z

The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income. Under these same treaties, residents or citizens of the United States are taxed at a reduced rate, or are exempt from foreign taxes, on certain items of income they receive from sources within foreign countries. Most income tax treaties contain what is known as a "saving clause" which prevents a citizen or resident of the United States from using the provisions of a tax treaty in order to avoid taxation of U.S. source income.

If the treaty does not cover a particular kind of income, or if there is no treaty between your country and the United States, you must pay tax on the income in the same way and at the same rates shown in the instructions for the applicable U.S. tax return.

Many of the individual states of the United States tax income which is sourced in their states. Therefore, you should consult the tax authorities of the state from which you derive income to find out whether any state tax applies to any of your income. Some states of the United States do not honor the provisions of tax treaties.

This page provides links to tax treaties between the United States and particular countries. For further information on tax treaties refer also to the Treasury Department's [Tax Treaty Documents](#) page.

A

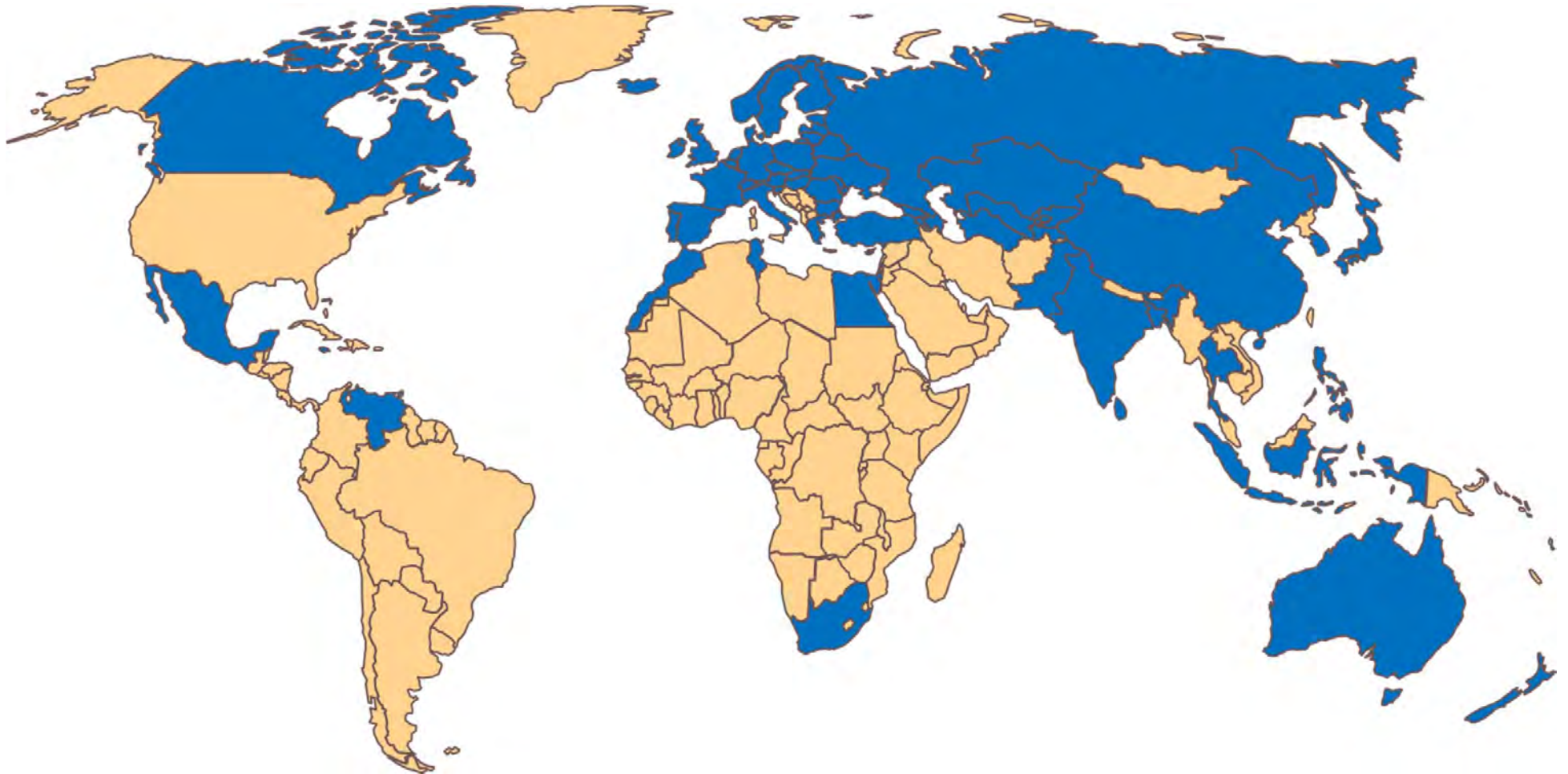
- [Armenia](#)
- [Australia](#)
- [Austria](#)
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B

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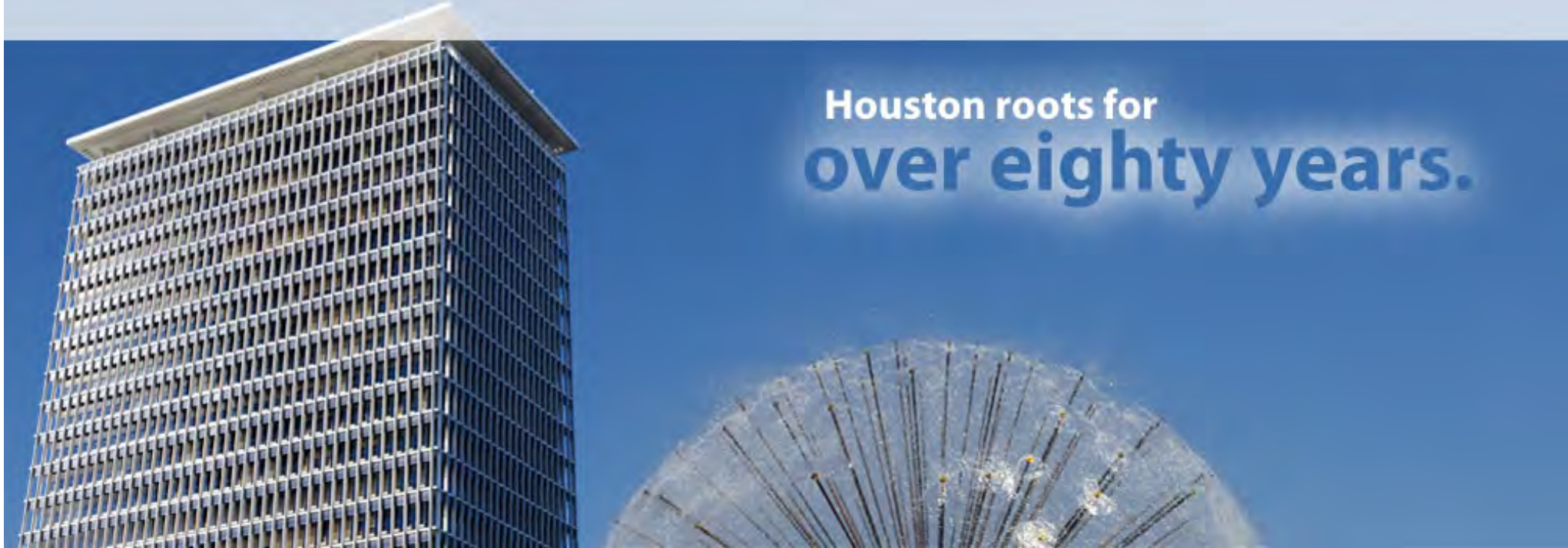
Income Tax Treaty Partners



U.S. Income Tax Treaties

- * *Cole v. Comm'r.*, T.C. Summ. Op. 2016-22.
 - * U.S. citizen gets caught by the U.S.-Israel Savings Clause.
- * *Topsnik v. Comm'r.*, 146 T.C. No. 1 (2016).
 - * You must be a resident to claim treaty benefits.

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