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TAX SECTION
STATE BAR OF TEXAS

www.texastaxsection.org

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Dear Fellow Tax Section Members:

It's hard to believe that we are over halfway through our 2016-2017 fiscal year. We are in the middle of Winter already, although some parts of the world would consider our winter temperatures spring or summer. But let's not move any faster than we already are!

There is much happening at the Tax Section these days. Below is my mid-Winter recap.

In Memoriam: Vester T. Hughes

We were saddened to learn that a prominent member of the Tax Section, the legendary Vester T. Hughes, passed away on Sunday January 29, 2017. The Tax Section promptly sent a notice to its members on January 31st with an In Memoriam in honor of Mr. Hughes. A copy of the In Memoriam is included in this publication. Mr. Hughes was a partner at K&L Gates LLP. Among his many accomplishments were his contributions to the Tax Section of the State Bar. He served as Chair of the Tax Section in 1966 -1967. In 2003, he became the first recipient of the Outstanding Texas Tax Lawyer Award by the Tax Section. The In Memoriam in this publication includes additional information regarding Mr. Hughes and his many other accomplishments.

International Tax Symposium

The 19th Annual International Tax Symposium took place November 3rd (Dallas) and November 4th (Houston). The event continues to be a success each year. Between the two locations, there were 76 attendees. This reflects an increase in the Houston attendance over last year. The Tax Section received positive comments from attendees on the quality of speakers and topics. Already, the Tax Section has some new sponsors lined up for this event in 2017.

Tax Law in a Day

The Tax Section recently completed its annual Tax Law in a Day program on Friday, February 3, 2017. This CLE program was started several years ago as a means of providing basic level tax continuing education and is available to both CPAs and attorneys. This year's event took place at the Cityplace Conference Center in Dallas, Texas and reported a record attendance. Many thanks to Lora Davis, Laurel Stephenson and everyone else who helped make the program a continuing success.

Leadership Academy

The Leadership Academy had its final event for the most recent class on January 18, 2017 in Austin, Texas. The event consisted of an all-day series of meetings at the offices of Norton Rose Fulbright followed by a reception and graduation dinner. Emily Parker with Thompson & Knight was the commencement speaker. There were 20 graduating members of this class, which marks the third such class offered by the Tax Section. Congratulations to the 2016-2017 Class!

In addition, the Tax Section recently completed a promotional video for the Leadership Academy that will be made available on the Tax Section's website for future applicants. Applications for the next installment of the Leadership Academy should be available later this year.

Committee on Governmental Submissions

The Committee on Governmental Submissions continues to operate like a well-oiled machine to coin a phrase from a well-known politician! Already, COGS has completed 12 comment projects for the year with the State and Local Tax Committee at the lead. Included in this number was a comment project submitted by the Tax Section jointly with the Texas Society of CPAs having to do with in-person IRS Appeals Conferences. Several other projects are currently underway as well.

Law School Outreach/Law School Scholarship Applications

The Tax Section's Law School Outreach initiative is well underway. The Tax Section has provided panel presentations to law students at Southern Methodist University, Texas Tech University, Texas A&M University, Texas Southern University and St. Mary's University. South Texas College of Law – Houston and the University of Texas are both on the calendar for March 7, 2017 while the University of Houston is scheduled for April 6, 2017. Many thanks to Abbey Garber for his continued hard work and dedication to this program.

The application period for law school scholarships opened on January 16, 2017. Applications are available on our website. These scholarships are intended to assist students with their financial needs, facilitate and encourage students to enter the practice of tax law in Texas, and become active members of the State Bar Tax Section. **Applications must be postmarked or received by April 7, 2017**. The scholarships will be awarded at the State Bar Annual Meeting in June 2017 in Dallas.

Section Representative to the State Bar of Texas Board of Directors

The Tax Section recently nominated Elizabeth Copeland to serve as the Large Section Representative to the State Bar Board of Directors. There was one opening for this position and each of the 5 Large Sections of the State Bar submitted their own nominees. Our very own Elizabeth Copeland won the nomination and will be serving as Large Section Representative to the State Bar Board of Directors for the 2017 to 2020 term. Congratulations Elizabeth!

Outstanding Texas Tax Lawyer Award

The nominations period for the annual Texas Tax Lawyer Award opened on January 6, 2017. An e-blast was sent to all members on January 9, 2017. Help us continue this long-standing tradition by nominating a qualified candidate. Nomination forms are available on the Tax Section website. Nominations should be submitted to Catherine Scheid, Tax Section Secretary, at ccs@scheidlaw.com no later than April 1. The award will be presented at an awards dinner on Thursday, June 22 in Dallas, Texas in conjunction with the 2017 Annual Meeting of the Tax Section.

Deadline for the Spring Edition of the *Texas Tax Lawyer*

The deadline for submitting articles for the Spring edition of the *Texas Tax Lawyer* is April 14, 2017. Any members interested in submitting articles should contact Michelle Spiegel at michelle.spiegel88@gmail.com.

Join a Committee

We have an active set of committees, both substantive and procedural as in previous years. Our substantive committees include: Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Gift Tax, General Tax Issues, International Tax, Partnership and Real Estate, Property Tax, Solo and Small Firm, State and Local Tax, Tax Controversy, Tax-Exempt Finance, and Tax-Exempt Organizations. In addition, our facilitator committees include: the Committee on Governmental Submissions, Annual Meeting Planning Committee, Continuing Legal Education Committee, Newsletter Committee, and Tax Law in a Day Committee.

Any members interested in joining a committee can do so by visiting our website at www.texastaxsection.org.

Contact Information

Below is my contact information as well as the contact information for our Tax Section Administrator, Kelly Rorschach, if anyone would like additional information:

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TAX SECTION
STATE BAR OF TEXAS

January 31, 2017

Vester T. Hughes, Jr.

The State Bar of Texas Tax Section mourns the passing of legendary tax attorney, Vester T. Hughes, Jr. Mr. Hughes was a partner at K&L Gates LLP. He made numerous contributions to the legal community and the profession. In 2003, he was the first recipient of the Outstanding Texas Tax Lawyer Award by the State Bar of Texas and the recipient of the Outstanding Fifty-Year Lawyer Award from the Texas Bar Foundation. He served as Chair of the State Bar of Texas Tax Section in 1966 -1967.

Mr. Hughes' many years of private practice have spanned many aspects of federal taxation—income, estate, gift and excise — individual and corporate. He argued two cases before the United States Supreme Court and served as lead counsel in two additional cases before the court, one of which was decided March 7, 2005, in favor of his client.

Mr. Hughes graduated cum laude from Harvard Law School, where he was Editor of the Harvard Law Review. After graduating, Mr. Hughes clerked for U.S. Supreme Court Justice Tom C. Clark.

A service for Mr. Hughes is scheduled for 2 p.m. Monday, February 6, 2017 at Park Cities Baptist Church, 3933 Northwest Parkway, Dallas, 75225. A reception will follow.

NOMINATION FOR 2017 OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Nominee Mailing Address, Phone, and Email:

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Description of Nominee's Contributions/Experience Relating to Taxation Law (please attach additional sheets if needed):

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Nominator Name: ____

Nominator Mailing Address, Phone, and Email:

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January 18, 2017

Scholarship Opportunity for Law Students Having an Interest in the Study and Practice of Tax Law in Texas!

The Tax Section of the State Bar of Texas annually awards up to three $2,000 scholarships to students demonstrating academic excellence and commitment to the study and practice of tax law. Any student who is enrolled in an ABA accredited law school at the time the application is submitted and who intends to practice tax law in Texas is eligible to apply. We need you to help us spread the word about this scholarship.

The purpose of this scholarship is to assist students with their financial needs, facilitate and encourage students to enter the practice of tax law in Texas, and become active members of the State Bar Tax Section. Selection criteria of the scholarships include: merit, scholastic performance, financial need, and demonstrated experience and interest in the field of tax law. Consideration is also given to extracurricular activities both inside and outside law school, including but not limited to legal externships or internships with state or federal taxing authorities such as the Internal Revenue Service, Office of the Texas Comptroller of Public Accounts, or Texas-based legal aid societies and clinics.

Applications must be postmarked or received by April 7, 2017. The scholarships will be awarded at the State Bar Annual Meeting in June 2017 in Dallas. Winners need not be present to accept the award.

A word version of the scholarship application is here. Please contact me if you have any questions.

Thank you in advance for your help.

-Rob Morris
Chair, Scholarship Committee

TAX SECTION
State Bar of Texas

Law Students Pursuing Tax Law Scholarship Application

The Tax Section of the State Bar of Texas annually awards up to three $2,000 scholarships to students demonstrating academic excellence and commitment to the study and practice of tax law. Any student who is enrolled in an ABA accredited law school at the time the application is submitted, and who intends to practice tax law in Texas is eligible to apply. Thus, persons who have been accepted to law school but have not yet started classes at the time the application is filed are ineligible to apply. However, persons who have recently graduated at the time the scholarship is awarded are eligible to apply.

The purpose of this scholarship is to facilitate and encourage students to enter the practice of tax law in Texas, and to become active members of the State Bar Tax Section, by assisting these students with their financial needs. Selection criteria of the scholarships include: merit, scholarship performance, financial need, and demonstrated experience and interest in the field of tax law. Consideration is also given to extracurricular activities both inside and outside law school, including but not limited to legal externships or internships with state or federal taxing authorities such as the Internal Revenue Service, Office of the Texas Comptroller of Public Accounts or Texas-based legal aid societies and clinics.

A completed application must be returned either by: (1) mail to the State Bar of Texas Tax Section's Scholarship Selection Committee, c/o Rob Morris, Norton Rose Fulbright, 1301 McKinney, Suite 5100, Houston, Texas 77010; or (2) email to Rob Morris at robert.morris@nortonrosefulbright.com.

<u>All information, including supporting documentation such as letters of recommendation and transcripts, must be included in a single submission. Transcripts do not need to be in original or certified form. If documents are submitted via email, please scan all of the documents and attach the scan to an email as a single document in PDF form. Incomplete applications will not be accepted.</u>

Applications must be postmarked or time stamped by no later than **April 7, 2017**. The scholarships will be awarded at the State Bar Annual Meeting in June 2017 in Dallas. Winners need not be present to accept the award.

Please print or type.

I. GENERAL INFORMATION

NAME: ____

E-MAIL ADDRESS: __________________________

MAILING ADDRESS: ____

____

HOME PHONE: ______________________ ALTERNATE PHONE: _____________________

II. EDUCATIONAL INFORMATION

LAW SCHOOL NAME: ____

GPA (cumulative): ______________ EXPECTED GRADUATION DATE: __________

CLASS RANK: __________

UNDERGRADUATE COLLEGE NAME: ____

DEGREE: ____ MAJOR: ___________ GPA: ______ GRADUATION DATE: _______

GRADUATE DEGREES including LL.M. Programs (College, Degree, Date):

____

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Please attach a copy of all college, graduate school (if any) and most recent law school transcripts. If your law school transcript does not include your grades for the most recent closed grading term, please separately provide information on all grades you have received to date and supplement your application with remaining grades as soon as possible after you receive them.

LAW SCHOOL ACTIVITIES AND/OR HONORS:

COMMUNITY ACTIVITIES:

Responses regarding law school activities and/or honors and community activities may be made in typewritten form of no more than one page in length.

III. RECOMMENDATIONS AND ESSAY

Please attach (1) one or more letters of recommendation and (2) a typewritten essay of no more than two pages in length (double spaced) addressing the following:

- Why you plan to pursue a career in tax law in Texas;
- What are your long-term career goals;
- List of the tax courses you have taken and grade received, and tax courses you are currently taking; and
- Any qualifications that you believe are relevant for your consideration for this scholarship. For example, students may describe relevant research, published articles, clubs, competitions, clinics, community service, job or internship or externship experience.

- (Optional) Any issues of financial need that you would like the Committee to consider.

AFFIRMATION OF APPLICANT: By signing below, I certify that all the information provided as part of this application is true and correct. I understand that the Tax Section's Scholarship Selection Committee reserves the right to investigate all information stated in this application.

Applicant's Signature: ___________________________________ Date: _______________

Great Expectations – Possible Tax Changes from President Trump

***by Jeffry M. Blair*[1]**

Although much of the United States has seen an increase in seismic activity over the last few years, nothing fully prepared people for the jolt they received this past November 8th. On that night, the electorate sent shockwaves reverberating across the country with the election of Donald J. Trump as the 45th President of this United States. In addition, to Mr. Trump's victory, the Republicans also retained control of both the House and the Senate. This leaves open the strong possibility that the new POTUS will be able to get approval for much of his tax plan that was proposed during the campaign (the "Trump Tax Plan"). S corporations (and potential S corporations) and their shareholders as well as owners in other pass-through entities, such as LLCs and partnerships, will want to look at the details of the Trump Tax Plan and keep in mind how these changes (if adopted) could impact their tax planning.

Individual Income Tax

There are several proposed changes to the federal income taxes that would positively impact individuals. A short summary of these proposed changes is as follows:

- *Lower and Fewer Income Tax Brackets*. The Trump Plan proposes to collapse the current seven federal income tax brackets down to three income tax rates. Assuming that the applicable taxpayers file as married filing jointly, the applicable tax brackets under the Trump Tax Plan would be as follows:

Individual Federal Income Tax Brackets under Trump Plan

Ordinary Income Rate	Net Long-term Capital Gains Rate	Single Filers	Married Joint Filers
12%	0%	$ 0 to $37,500	$0 to $75,000
25%	15%	$37,500 to $112,500	$75,000 to $225,000
33%	20%	> $112,500	> $225,000

This proposed change represents a reduction of 6.8% in the highest federal income tax rate imposed on individuals from 39.6% down to 33.0%. This would reduce the income tax rates on many S corporation shareholders as well as income tax rates on partners in partnerships and members in LLCs treated as partnerships for federal income tax purposes. For existing pass-through entities, this could result in such entities being able

[1] Jeffry M. Blair is a partner in the Tax & ERISA group. This article presents the views of Mr. Blair and does not necessarily reflect those of Hunton & Williams or its clients. The information presented is for general information and education purposes. No legal advice is intended to be conveyed; readers should consult with legal counsel with respect to any legal advice they require related to the subject matter of the article. Mr. Blair writes frequently on tax topics and may be reached at (214) 468-3306 or jblair@hunton.com.

to retain a large amount of funds that would currently have to be distributed to the owners of such entities to pay taxes.

The Trump Tax Plan will retain existing long-term capital gains tax rates (i.e. maximum federal income of 20%).

Carried interests will be taxed at ordinary income tax rates. This provision would be expected to primarily impact partnerships and entities such as LLCs treated as partnerships for federal income tax purposes by impacting the characterization of their back-end interests in those investment entities.

Repeal 3.8% Medicare Surtax. The 3.8% surtax on net investment income (often called the Obamacare Tax) will be repealed. Currently, owners of pass-through entities (such as S corporations, partnerships and LLCs treated as partnerships for income tax purposes) that are not actively participating in those pass-through entities can be subject to a 3.8% surtax on their allocation of the passed-through income. With this repeal, the owners that are not treated as materially participating in the business of a pass-through entity would no longer be subject to this 3.8% tax on their allocable income from that pass-through entity. This repeal would also keep the maximum federal income tax rates for ordinary income and net long-term capital gains under the Trump Tax Plan at 33% and 20%, respectively.

- Repeal the AMT. The alternative minimum tax ("AMT") on individuals will be repealed. This could increase the issuance of incentive stock options ("ISOs") rather than non-qualified stock options ("NSOs") since ISOs would no longer be subject to the payment of the AMT would no longer apply to ISOs.

- Standard Deduction. Increase the standard deduction for married filing joint filers from $12,600 to $30,000 and for single filers from $6,300 to $15,000.

- Cap on Itemized Deductions. Cap the itemized deductions at $100,000 for single filers and $200,000 for married couples filing jointly.

- Eliminates Head of Household Filing Status. The elimination of head of household as a filing status could impact individuals who would qualify for this filing status. Although the reduction in tax rates would mitigate some of this impact, certain of these shareholders could have an increase in their federal income taxes depending on their exact circumstances.

- Childcare Deduction. Childcare costs would become deductible from adjusted gross income for most Americans (i.e. an "above-the-line" deduction) up to the average costs of care in their state. The deduction would be phased out for individuals earning more than $250,000 or couples earning more than $500,000.

- Spending Credits. Credits of up to $1,200 a year for childcare expenses would be paid to lower-income families, through the earned income tax credit.

- New Savings Accounts. New savings accounts for the care of children or elderly parents, or school tuitions will be made available with offers of 50% match of contributions.

Care must be taken in evaluating the potential tax impact to each taxpayer. While most taxpayers should see a decrease in their federal income taxes, the interaction of the elimination of some of these taxes and the reduction in tax brackets could result in an increase in taxes for some taxpayers.

Corporate/Business Taxes

The Trump Tax Plan also proposed to make several positive changes to reduce the taxes of corporations. These proposed changes are as follows:

- Lower Corporate Tax Rate. The proposed Trump Tax Plan will reduce the maximum corporate federal income tax rate from 35% to 15%. As a result of this proposed change and the proposed reductions in individual income tax rates, the effective tax rate on income earned by a C corporation and distributed to its shareholders would be 32% compared to a 33% top rate on ordinary income through an S corporation. Accordingly, if both of these provisions were passed, the effective tax rates on distributions of operating income from C corporations and from S corporations would be nearly the same. However, the Trump Tax Plan also called for limiting the top individual tax rate on income from pass-through businesses to 15%. This would result in only a 15% federal income tax rate to individuals on their pass-through income from S corporations, partnerships, LLCs and other such entities.

- Repeal AMT. Repeal the alternative minimum tax on corporations.

- Election to Deduct Capital Investment. An entity engaged in manufacturing in the United States may elect to expense capital investment and lose the deductibility of corporate interest expense. An election once made could only be revoked within the first 3 years of election and, if revoked, returns for prior years would need to be amended to show revised status. After 3 years, the election would be irrevocable.

- Repatriation Tax. The Trump Tax Plan would provide that a deemed repatriation offer a one-time tax rate of ten percent (10%) on the deemed repatriation of corporate undistributed earnings and profits from a foreign subsidiary.

- Increase in Tax Credit for On-Site Childcare. The annual cap for the business tax credit for on-site childcare authorized by Section 205 of the Economic Growth and Tax Relief Reconciliation Act of 2001 would be increased to $500,000 per year (up from $150,000) and recapture period would be reduced to 5 years (down from 10 years).

- Deduction of Payment for Employee Childcare. Businesses that pay a portion of an employee's childcare expenses can exclude those contributions from income. Employees who are recipients of direct employer subsidies would not be able to exclude those costs from the individual income tax and the costs of direct subsidiaries to employees could not be used as a cost eligible for the credit.

Repeal Estate (Death) Tax. The Trump Tax Plan will repeal the estate tax imposed at death, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed. Under this proposal, the tax basis of a decedent's assets would not receive a step-up at death and would carryover to the heirs. Accordingly, this would increase the income taxes to heirs who want to sell the inherited assets. In addition, it will likely cause tax basis verification issues with heirs who inherit assets that have been held for much of the decedent's life or longer.

Potential Impact to Taxpayers and Their Tax Planning

If passed in its entirety, the Trump Tax Plan could have a tremendous impact on S corporations and their shareholders as well as on other pass-through entities such as partnerships and LLCs and their owners. It would reduce the federal income tax on individuals holding interests in such pass-through entities to a maximum of 15% on their allocation of income. For owner-employees of pass-through entities, this would create incentives to take less out of the business as compensation and more as pass-through income. It could also impact the decision of some employees on how best to be compensated for their services. Furthermore, the proposed changes would provide additional incentives for C corporations to take the steps necessary to convert to S corporations to take advantage of the lower income tax rates.

Although the elimination of the estate tax, the alternative minimum tax, and the net investment income tax would result in a much simple tax code, the Trump Tax Plan would also result in some additional complexities. For example, the elimination of estate taxes will result in a carryover tax basis of inherited assets to the decedent's heirs. This increases the need to maintain good tax records that accurately document and keep track of the tax basis of assets that will be inherited.

However, most economists believe that the Trump Tax Plan would result in large decreases in federal income tax revenues. Although most taxpayers that are actually paying some federal income tax will see a reduction in their federal income taxes, most of the decrease is expected to be received by the top 20% of taxpayers. Accordingly, it is likely to face opposition from most Democrats and some Republicans. This could result in passage of some but not all of Trump Tax Plan. It could also result in additional limitations and/or taxes to offset some of the above savings.

As earth shaking as was the election of Donald Trump as President, the passage of all or most of the Trump Tax Plan could have an even greater seismic impact on taxpayers and their investments for years to come.

UNFINISHED BUSINESS: LOOKING AHEAD TO THE TRUMP ADMINISTRATION

EMPLOYEE BENEFITS LEGISLATION PROPOSED (BUT NOT PASSED)

BY THE OBAMA ADMINISTRATION

By James R. Griffin
Partner, Jackson Walker L.L.P.

This article was originally published by Jim Griffin as a series on LinkedIn over the three weeks leading up to Inauguration Day.

Introduction

In February of 2015, the Department of Treasury issued a reported entitled "General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals" (the "General Explanation"). The General Explanation is several hundred pages long and includes detailed proposals for new Federal tax legislation. If adopted, many of these proposals would have been effective in years beginning after December 31, 2016. With a sharply divided Congress and a lame duck President, however, it is not a surprise that none of the proposals have become law.

Now, as we move to a new Congress and new President, there is much speculation about what legislative changes we should expect starting in 2017. In the area of employee benefits, little of this speculation is based on any concrete ideas or proposals from President-elect Trump, other than, of course, the promise to repeal ObamaCare.

We may not know what the Trump Administration will bring in the way of employee benefits legislation, but I, for one, am confident that the ideas of the Obama Administration will be left behind. Whatever the proposals are for 2017, it seems reasonably clear they will be quite different from the proposals in the General Explanation.

I thought it might be useful (and fun) to take one final look at the employee benefits legislation proposed in the General Explanation. These ideas might not see the light of day for the next four years, or ever.

Mandatory Payroll Deduction IRAs

According to the General Explanation, employers that have been in business for at least two years and have more than ten employees would be required to offer a payroll deduction IRA savings plan. The required IRA plan would have an automatic enrollment feature with a default savings rate of three percent. Employers that offer a qualified retirement plan, SEP, or SIMPLE would not be subject to this requirement.

Contributions would be invested in a "low-cost, standard type default investment" and a "handful of standard, low-cost investment alternatives would be prescribed by statute or regulation." In addition, a national website would provide information and basic educational material regarding savings and investing for retirement. Tax credits would be expanded to encourage plan formation by employers and contributions by employees.

At least five states (including California, Connecticut, Illinois, Maryland and Oregon) have recently adopted their own versions of mandatory payroll deduction IRAs for state government employees who are not covered by a public pension system. It seems unlikely to me, however, that the Trump Administration will move to burden small business with the requirement to adopt payroll deduction IRAs.

The General Explanation contains an ominous note that no more than about half of the total work force participates in employer-sponsored retirement plans. That statistic may end up in a policy maker's cost-benefit analysis when trying to find ways to raise revenue in Washington.

Expansion of the Exception to the 10% Early Distribution Penalty Tax for the Long-Term Unemployed

The tax law imposes a 10% penalty tax on early distributions from IRAs and qualified plans. The penalty tax is intended to encourage taxpayers to use assets in those accounts for retirement purposes. For the unemployed, however, current needs take precedence over long term retirement savings. In those situations, the 10% penalty tax erodes limited resources available to the unemployed without having a substantial deterrent effect.

Congress created an exception to the 10% penalty tax for distributions from IRAs for individuals who are unemployed, but that exception does not apply to qualified plan distributions. The Obama Administration proposed to expand the exception for the unemployed to cover potentially larger distributions from IRAs and to cover qualified plan distributions. The General Explanation describes the complicated rules and limits that would apply to the proposed new exception. The proposal would exempt IRA and qualified plan distributions of up to $50,000 per year for each of two years during a single period of long-term unemployment. New codes would also be added to Form 1099-R to facilitate taxpayer compliance and reporting for the new exception.

The proposal would serve a useful purpose to lessen the tax burden on unemployed individuals. However, the details of the proposal limit its usefulness and increase the compliance burden on taxpayers. Assuming that President Trump is successful in his plan to "make America great again", unemployment will decline and the need for the exception will go away. Regardless, I don't expect to see this proposal again in the next four years.

401(k) Plan Eligibility for Part-Time Employees

The General Explanation suggests that retirement savings may be improved if part-time employees are given the opportunity to contribute to their employer's 401(k) plan. Based on that premise, the Obama Administration proposed to change the retirement plan rules to require employers to allow 401(k) contributions by part-time employees.

Not all part-time employees would be eligible to make 401(k) contributions. Employers would have to track hours of service for part-time employees. Only those part time employees who worked at least 500 hours per year with the employer for at least three consecutive years would be eligible. Accordingly, short service part-time employees would continue to be excluded.

Matching contributions would not be required. Top heavy and nondiscrimination testing rules would be amended to exclude the newly eligible part-time employees.

Separate from the Obama proposal, employers should know that the IRS does not allow part-time employees to be excluded from a 401(k) plan. The IRS interprets the 1,000 hour of service requirement as the only mechanism for excluding part-time employees from 401(k) plan participation. Accordingly, a 401(k) plan should not be drafted or administered to categorically exclude part-time employees from 401(k) plan eligibility. If part-time employees are excluded from a 401(k) plan, the 401(k) plan may have a plan document and/or operational error that would need to be corrected in the Employee Plans Compliance Resolution System (EPCRS).

Aside from the practical question about how much money a part-time employee could or would be willing to save in a 401(k) plan, there is the question of whether this proposal is worth the additional recordkeeping burden that would be imposed on employers. Also, the proposal would make 401(k) plans even harder for employees to understand.

With annual contribution limits of more than $5,000 per year, IRAs provide a reasonable alternative to this proposal. My prediction is that expanded 401(k) plan eligibility for part-time employees will not come back around for consideration in the next four years.

Facilitating Annuity Portability

One of the important policy initiatives of the Department of Treasury has been to reduce or eliminate barriers to offering lifetime income options inside 401(k) plans. This would make it possible for participants to view their 401(k) accounts in terms of an income stream rather than as an account balance. Officials inside the Treasury believe that this change would make it easier for participants to avoid either under- or over- spending in retirement.

According to the General Explanation, the Treasury believes that the distribution restrictions in Section 401(k) discourage employers from including annuity investments in their 401(k) plans. The General Explanation observes that there is no good option for handling an annuity if the employer wants or needs to remove the annuity investment option from the 401(k) plan. This may result in surrender charges or penalties if the annuity investment option is discontinued due to a change in recordkeeper, custodian or trustee.

Under the proposal, participants would be permitted to roll over an annuity investment option if the annuity is no longer authorized to be held by the 401(k) plan. This rollover option would be available even when the participant would not be eligible to receive a distribution from the 401(k) plan.

This proposal would be favored by the insurance industry and would promote lifetime income planning with 401(k) plan assets. It is possible that, with some revisions, this proposal may find its way into a round of benefits legislation within the next four years.

Simplification of Minimum Required Distribution Rules

The Obama Administration proposed to exempt small retirement and IRA balances from the minimum required distribution ("MRD") rules. In the case of IRAs, those rules require that annual distributions begin after the account holder reaches age 70½. In the case of 401(k) plans and other retirement plans, annual distributions must begin after the participant reaches age 70½ or retires, whichever is later.

The General Explanation describes a proposal to aggregate all of a taxpayer's retirement accounts to determine whether the total value is more than $100,000. The MRD rules would only apply to taxpayers with large retirement balances. This makes a great deal of sense without jeopardizing the tax collection system and allows older citizens to defer distributions without the stiff 50% penalties that backup the MRD requirement.

Another part of the same proposal would be much more controversial by imposing the MRD rules on Roth IRA balances.

I'll call the first part of this proposal a toss-up. It is possible that we might see legislation that exempts small balances from the MRD requirements. The Roth IRA proposal, however, will generate some very stiff opposition and be unlikely to pass, especially in the next four years.

Simplification of IRA Rollover Rules for Surviving Non-Spouse Beneficiaries

The Internal Revenue Code currently differentiates between spouse and non-spouse beneficiaries in the mechanics of processing a rollover. A beneficiary who is not a surviving spouse may rollover assets from a tax-favored retirement plan into an IRA only by using a direct rollover. A 60-day rollover is not available to a surviving non-spouse beneficiary.

A similar problem is that a surviving non-spouse beneficiary may treat inherited IRA assets as a non-spousal inherited IRA and may move the assets to another non-spousal inherited IRA only by using a direct trustee-to-trustee transfer. Rollovers from a deceased owner's IRA to another IRA are not allowed for a surviving non-spouse beneficiary.

The General Explanation recognizes that this amounts to nothing more than a game of Trivial Pursuit (my words) that creates "traps for the unwary." The Obama Administration proposal would allow the 60-day rollover in each of these situations.

This is a reasonable proposal that would clean up the Internal Revenue Code and make it more workable and understandable for taxpayers. Accordingly, it should be quite likely that any reasonable administration would seek to put this change forward at the next opportunity.

Death of the Stretch IRA

The words "Stretch IRA" have emerged over the last few years to apply to beneficiary designation planning for IRA account holders to defer income tax by extending an IRA's distribution period over the life expectancy of a beneficiary after the death of the participant.

The General Explanation points out that the preference for retirement savings in the Internal Revenue Code exists primarily to provide retirement security for individuals and their spouses. These preferences were not created with the intent of providing tax preferences to the non-spouse heirs of individuals.

The Obama Administration proposal would have changed the distribution rules to provide that non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Extended payments would be allowed for eligible beneficiaries who are disabled, chronically ill, or not more than 10 years younger than the participant or a minor child of the participant.

This provision would simplify tax administration and planning for individuals and would raise some revenue by shortening permissible deferral periods. It is hard to know whether the amount of revenue that could be raised would be significant. Certainly, eliminating extended IRA payouts for non-spouse beneficiaries would be unpopular with some, but it is doubtful that this provision would attract a significant amount of vocal adverse attention.

For that reason, I suspect that it is possible we might see this provision in a proposal again within the next four years.

Limitation on Tax Deferred Accumulations

The Obama Administration proposed to limit the amount that taxpayers may save in their tax deferred accounts. The proposed limit would apply to the combined balance in a taxpayer's defined benefit plans, defined contribution plans, IRAs, 403(b) plans, and 457(b) plans.

According to the General Explanation, imposing a limit on tax deferred accumulations would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels. Initially, the limit would be $3.4 million, along with fairly generous grandfathering rules.

Taxpayers who have saved more than $3.4 million in their tax deferred accounts would not be allowed to make further contributions. Any excess contributions would be taxable to the individual both at the time of contribution and at the time of distribution.

In 1986, President Reagan enacted a similar limit as part of the Tax Reform Act of 1986. The limits were contained in the excise tax provisions of Internal Revenue Code Section 4981A which applied to large accumulations and distributions. The Reagan limits in Section 4981A were repealed in 1997.

Politicians in both parties seem to be attracted to limits on tax deferred savings so it is hard to predict whether savings limits may be enacted in the next four years. My bet on this one is that we will not see similar legislation in the Trump Administration.

SECA Tax Parity for Professional Service Businesses

This proposed change is not a pure benefits issue but is important enough to be included here.

The General Explanation notes that the imposition of employment taxes on owners of pass through entities is outdated, unfair, and inefficient. According to the General Explanation, employment taxes are imposed as follows:

- general partners and sole proprietors pay employment taxes on nearly all of their earnings
- S corporation owner-employees pay employment taxes on only a portion of their earnings
- limited partners and many LLC members pay little employment tax at all

To even the playing field and eliminate employment tax as a choice of entity decisional factor, the Obama Administration proposed that individual owners of professional service businesses that are organized as S corporations, limited partnerships, general partnerships, and LLCs that are taxed as partnerships would all be treated as subject to self-employment tax in the same manner and to the same degree.

Professional service businesses include those engaged in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. Material participation would be determined under rules similar to the passive activity loss rules.

This change has a lot of ripple effects, especially in the area of fringe benefits, cafeteria plans, and qualified plans. I am not sure whether all of those issues have been fully explored. For now, I'd bet we will not see this change in the next four years. However, this is an area that may be subject to review and reclassification by IRS on audit.

Closing the Backdoor on Roth IRA Conversions

Roth IRAs first became available in 1997 and since then have become an important tool in retirement planning. Congress initially imposed limits that kept the Roth IRA out of reach of high income taxpayers. But in 2010, Congress opened a backdoor to Roth IRAs by permitting non-Roth IRAs to be converted to Roth IRAs. The backdoor is made even larger if the funds in the non-Roth IRA are from after-tax contributions because then the conversion to Roth IRA can be accomplished virtually income tax-free.

The General Explanation does not describe why this is an abuse and does not provide any policy reasons for the change suggested. Nonetheless, the General Explanation sets forth a proposal to permit conversions to Roth IRA only for funds that are includable in income. This change would close the backdoor on Roth IRA conversions.

This is a fairly technical change that has a small impact on a small number of taxpayers who are all high-income earners. I think it is quite possible that this change could be included in a tax code clean-up bill during the next four years.

Eliminating the Dividend Deduction for Public Company ESOPs

The Internal Revenue Code contains numerous provisions designed to encourage the formation of employee stock ownership plans ("ESOPs"). One of those benefits is a provision that allows a corporation to claim a federal income tax deduction for the amount of dividends paid on its own stock held in an ESOP. To qualify for the deduction, the dividend must meet several complex requirements.

The General Explanation reveals the Obama Administration's concern that ESOPs pose a risk to workers by concentrating their retirement savings in a single, undiversified investment. Accordingly, the Obama Administration proposed to repeal the deduction for dividends paid to an ESOP but only with respect to publicly traded corporations.

While this proposal may initially seem to be fairly limited in its application, the need for broader corporate tax reform may eliminate any interest in this as a stand-alone proposal. The only way this idea can move forward in the next four years is if it is politically sold as a part of a broader corporate tax reform proposal. Even then, it seems unlikely to me that this proposal will see serious consideration in the Trump Administration.

Repeal of NUA in Employer Securities

The net unrealized appreciation (NUA) rules provide a special tax benefit for participants in plans that invest in employer stock. Employees who receive a lump sum distribution in the form of employer stock may pay income tax at the time of distribution only on the amount that they paid for the stock inside the plan that is distributed to them. The NUA is taxed later at capital gains rates when the stock is sold.

The General Explanation maintains that the NUA rule encourages the undiversified investment in a single stock which subjects participants to an increased risk of loss. Accordingly, the Obama Administration proposed to eliminate the NUA rules for distributions to participants who had not reached age 50 by December 31, 2015.

This change might be embraced by tax advisors as a blessing in the form of simplification from the countless exceptions upon exceptions in the Internal Revenue Code. That alone, however, is not a sufficient reason for this change to be adopted. I don't believe that we will see this change included in a tax change in the next four years.

W-2 Reporting for Defined Contribution Plan Employer Contributions

The Obama Administration proposed legislation in Congress to require employers to report the amount of their contributions to their profit sharing and 401(k) plans on an employee's Form W-2. This provision serves no apparent useful purpose, especially given it is redundant of ERISA requirements to provide annual statements to participants. Moreover, there is growing opposition to increased reporting and disclosure obligations imposed on employers by all agencies at all levels.

The General Explanation timidly explains that a W-2 reporting obligation would provide workers with a better understanding of their overall retirement savings and compensation. The General Explanation also asserts that such a requirement would facilitate compliance with the tax code's annual addition limits.

My bet? Don't look for this proposal to come back around any time soon.

Worker Classification

And finally, we finish with a topic that deserves more certainty and finality than it actually receives.

Where the law is not clear and uniform, opportunities for unfair advantage and eventual disregard of the law will replace an orderly system of self-enforcement. That is precisely what has happened for years on the issue of worker classification.

Worker classification is the most important consideration that affects the relationship between a business and its workers. In its simplest form, the determinative question is: Who has the right to direct and control the manner and means by which the work is performed? If the answer is the business, then the worker is an employee. If the answer is the worker, then the worker is an independent contractor. From this simple test, the regulatory and protective effect of numerous laws and regulations naturally follows; including such things as tax withholding, employee benefits, and workplace safety.

According to the General Explanation, Section 530 of the Revenue Act of 1978 has precluded the IRS from issuing general guidance addressing worker classification and from taking enforcement action in certain cases.

The Obama Administration proposal would give the IRS more flexibility to correct worker classification issues prospectively. In addition, the proposal would provide for reduced employment tax liabilities for businesses that voluntarily reclassify their workers before being contacted by the IRS.

While the theme for the next four years seems to be less regulation, worker classification is an issue that deserves continued attention. Competition among businesses can be made more fair by a uniform set of worker classification rules that are clear and consistently applied. I believe that in the next four years we will see continued efforts to legislate and bring fairness to this important area.

Conclusion

Stay tuned over the next few weeks and months as the new administration begins to settle in and define its legislative goals. The details will be filled in by the lobbyists and the Congressional staffs. With the power to lead, it is reasonable to expect that changes in the Trump Administration are on the horizon. Now, we need to wait and see what those changes might be and whether any of the ideas that are part of the unfinished business of the Obama Administration will have another chance to make it to the finish line.

IRS CRIMINAL INVESTIGATION HITS BIG DESPITE SIGNIFICANTLY REDUCED RESOURCES – IT IS MORE IMPORTANT THAN EVER TO REMEDIATE PAST TAX RETURN ERRORS AND OMISSIONS

If you think it is open season and no one is minding the store for the IRS, think again. Despite unprecedented budget cuts to the IRS examination, collection and criminal investigation divisions, IRS Criminal Investigation ("CI") is going after taxpayers and tax advisors with a vengeance. They want everyone to know of and feel their presence. To increase the efficiency of CI, they have encouraged and are taking case referrals from the IRS examination and collection divisions. Accordingly, there is no longer such a thing as a routine IRS examination and collection case when there is any fact that could be interpreted as fraudulent. In these cases, CI already has the bulk of the work done for them. This is true especially with the help of the fraud technical advisors who, through the fraud referral program (including but not limited to the SEP – Special Enforcement Program – IRS group), work behind the scenes (in secret) to help IRS examination and collection turn mere badges of fraud into firm indications of fraud ready to be handed off to CI.

An effective way to avoid CI when the facts could be interpreted as fraudulent is to take advantage of IRS remediation through such a thing as the domestic and offshore voluntary disclosure programs and other IRS remediation options.

I. CHIEF'S MESSAGE

The Chief's Message in the IRS Criminal Investigation Fiscal Year 2015 National Operations Annual Business Report ("Report") is bursting with major victories for IRS Criminal Investigation. CI started the fiscal year with major budget cuts. Amazingly, CI hired merely 45 agents in the last three years, bringing staffing down to the lowest levels since the 1970s. Chief of CI, Richard Weber, when commenting on the reduction, stated reluctantly, "We finally came to realize that fewer agents and staff really do mean fewer cases."[1]

Despite the reductions in staffing, CI remained steadfast and busy during fiscal year 2015. Specifically, the FIFA investigation began as a tax evasion case and, thanks to CI agents, "snowballed" into something much more. CI also completed the case against the owner of the "Silk Road" website, resulting in a life sentence and a forfeiture order in excess of $183 million. Additionally, CI investigated Dr. Farid Fata, who purposefully misdiagnosed cancer to "get rich" and was an example to CI of "greed being a common link in all financial investigations."[2]

Next, CI took on identity theft, noting an increase in sophistication. The "Dark Net" created additional challenges in identity theft investigations along with the use of virtual currency. Over the last three years, CI has produced quality identity theft cases which, despite the budget and staffing challenges, have sent almost two thousand people to jail.

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[1] Report, p. 1.
[2] *Id*.

II. INVESTIGATIVE PRIORITIES

The 2015 Investigative Priorities[3] are:

1. Identity Theft Fraud;
2. Abusive Return Preparer Fraud & Questionable Refund Fraud;
3. International Tax Fraud;
4. Fraud Referral Program;
5. Political/Public Corruption;
6. Organized Crime Drug Enforcement Task Force (OCDETF);
7. Bank Secrecy Act and Suspicious Activity Report (SAR) Review Teams;
8. Asset Forfeiture;
9. Voluntary Disclosure Program; and
10. Counterterrorism and Sovereign Citizens.

III. CI STATISTICS

Investigations initiated fell from 5,314 in fiscal year 2013 to 4,297 in fiscal year 2014 to 3,853 in fiscal year 2015. This figure represents a 10% drop in investigations initiated from last year and a shocking 27.5% drop since fiscal year 2013.[4] The decrease in investigations is a major concern inside and outside of the IRS.

One reason for the decreased statistics is definitely the decrease in the number of IRS CI Special Agents. As of September 30, 2015, there were 2,316 CI Special Agents. This represents a 6% decrease when compared to the number of Special Agents at the conclusion of fiscal year 2014. Likewise, the professional staff in CI decreased 8.8%.[5] Think about the increase in the population of taxpayers since fiscal year 1995, which included the employment of a record high number of Special Agents at 3,363, compared to the reduced force of 2,316 Special Agents. The 31% reduction in the number of Special Agents is substantial. There is a belief that there is practically no one protecting the fiscal security of the country. Tax professionals throughout the country are encountering increasingly aggressive, and sometimes bizarre, tax schemes which at best straddle the civil criminal divide and often are actually criminal tax scams dressed up to resemble tax planning. While clients are lost to these charlatans, there is a grave concern that a number of tax practitioners will take the "if you can't beat them, join them" approach. With little perceived concern over being caught, this is a real danger. Congress must act quickly and decisively to save the tax system, a voluntary system which relies heavily on tax practitioners' advice to taxpayers.

[3] Report, p. 2.
[4] *Id*.
[5] Report, p. 3.

IV. LEGAL SOURCE TAX CRIMES

"Criminal Investigation's primary resource commitment is to develop and investigate Legal Source Tax Crimes."[6] Legal Source Tax Crimes are committed by taxpayers in industries and occupations that are legally permissible, whose actions are in violation of tax laws or "threaten the tax system." The prosecution of Legal Source Tax Crimes supports IRS compliance goals and enhances the voluntary compliance with tax laws.

A. FRAUD REFERRAL PROGRAM

CI "places a high degree of emphasis" on its fraud referral program. CI works closely with the civil divisions in Small Business/Self-Employed, Wage and Investment, Large Business & International, and Tax Exempt and Government Entities through the fraud referral program in these four divisions. Through the fraud referral program, CI is instituting core mission tax investigations. Finally, and most likely in response to criticisms of the past, CI is maintaining a commitment to the timely evaluation of every fraud referral from the fraud referral program.[7]

B. GENERAL TAX FRAUD: THE BACKBONE OF CI'S ENFORCEMENT PROGRAM

CI knows that general tax fraud investigations directly influence the public's tax compliance. This is of paramount importance. The entire system depends heavily upon self-assessment by taxpayers of the correct amount of tax and the voluntary filing of tax returns, including paying the amount of tax owed. Taxpayers from all different sectors of the economy, including corporate executives, small business owners, self-employed and wage-earners, through willful noncompliance, fail to report and pay their fair share of taxes. Accordingly, the financial investigative skills of CI Special Agents are the key to discovering the types of schemes that exist today. The following schemes[8] are on the CI radar:

1. Skimming by deliberately underreporting or omitting income;
2. Maintaining dual sets of books;
3. Creating false entries in books and records;
4. Classifying personal expenses as business expenses;
5. The use of false deductions or credits to decrease taxes; and
6. Hidden or transferred assets for the purposes of avoiding the payment of taxes.

An example of a general tax fraud investigation is a Pennsylvania man sentenced to 60 months in prison and ordered to pay $1.7 million in restitution for a scheme to use skimmed cash to pay expenses, resulting in the avoidance of paying millions of dollars in personal and employment taxes. The taxpayer pled guilty to conspiracy to commit tax evasion, filing false returns, loan fraud, and aggravated structuring of financial transactions.

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[6] Report, p. 6.
[7] *Id*.
[8] *Id*.

Another case involved a Las Vegas man who pled guilty to conspiracy, mail fraud, wire fraud, and tax fraud for a scheme to take control of a condominium homeowners association to secure contracts for himself. A final example of general tax fraud includes the old-fashioned obstruction of an IRS examiner through the provision of false and fictitious documents during the IRS examination of a pizza restaurant owner in a payroll tax evasion scheme.

C. REFUND FRAUD PROGRAM

Refund fraud continues to be a significant threat to the tax system. Criminals are attempting to misuse the tax system to obtain large refunds using false pretenses. CI is aware that in addition to the loss of much needed funds for vital programs, refund fraud directly impacts the confidence taxpayers have in the tax system and taxpayers' willingness to voluntarily meet their tax filing obligations. A major concern is violent criminal enterprises which have changed their modus operandi to focus on refund theft from the IRS and the U.S. government. The refund fraud program is broken down into two categories, the Return Preparer Program and the Questionable Refund Program. Both categories include an issue which has been a major thorn in the side of the Internal Revenue Service, as well as many ordinary taxpayers – specifically, identity theft.[9]

1. Identity Theft

CI continues to include identity theft-related crimes as a priority area of investigation. CI increased its emphasis with both administrative and grand jury investigations, and multi-regional task forces with state, local and federal law enforcement agencies. CI currently participates in over 70 task forces and working groups throughout the country.[10] CI has designated a management official to serve as the National ID Theft Coordinator to oversee nationwide efforts to combat identity theft. Additionally, within each of the 25 field offices, there is an ID Theft Coordinator.

A big driver for identity theft is data breaches. The uptick in tax-related identity theft can be linked to information acquired through data breaches. As a result of the impact and scale of false refunds based upon identity theft, 22 field offices initiated investigations linked to computer intrusions, account takeovers, and data compromises affecting tax administration.[11]

While identity theft continues to remain a large priority for CI, investigations initiated dropped from 1,063 in fiscal year 2014 to 776 in fiscal year 2015. However, with successful prosecutions, the amount in issue and the number of victims in the identity fraud cases continues to increase in magnitude as the IRS focuses on more elaborate and bigger refund schemes.[12]

2. Abusive Return Preparer Program

[9] Report, p. 8.
[10] *Id.*
[11] *Id.*
[12] Report, p. 11.

The Abusive Return Preparer Program is focused on tax preparers who prepare and file false income tax returns. The false items include inflated personal expenses, inflated business expenses, false deductions, exemptions in excess of the proper amount, and tax credits which are not permitted under the Code. Sadly, the taxpayers for whom the dishonest return preparers are working may or may not have knowledge that the returns themselves are false. This is always a delicate subject, as the taxpayers range from innocent victims to co-conspirators with the bad return preparer. Even an innocent taxpayer must pay the full amount of tax and interest when the return is corrected by the Internal Revenue Service. Those taxpayers will generally enjoy penalty relief, but the tax and interest is often financially devastating to these unsuspecting, innocent taxpayers. On the other hand, co-conspiring taxpayers can expect to receive the full attention of CI and often will end up being indicted or will plead guilty to a tax crime.

The statistics for investigations initiated are down for fiscal year 2015. In fiscal year 2014, 305 preparer investigations were initiated, whereas in 2015, 266 preparer cases were initiated.[13] It can certainly be argued that dishonest preparers are one of the biggest dangers to the integrity of the entire tax system. This is the reason the IRS has gone to great lengths to determine different ways in which to regulate and, when appropriate, discipline bad preparers.

3. Questionable Refund Program

The Questionable Refund Program identifies fraudulent claims for tax refunds. The IRS not only wants to prosecute the promoters of these false returns, but also wants to understand these false returns well enough to place filters within the computer system to stop the issuance of false refunds. For example, an Alabama woman was sentenced to 145 months in prison based upon leading a $4 million stolen identity refund fraud ring which filed more than 1,000 fraudulent tax returns claiming refunds in excess of $4 million.

The statistics for investigations initiated are down for fiscal year 2015. In fiscal year 2014, 1,028 preparer investigations were initiated, whereas in 2015, 775 preparer cases were initiated.[14] Absent increased activity by CI, these dishonest preparers will flourish and multiply.

D. ABUSIVE TAX SCHEMES

The abusive tax schemes program focuses on promoters and taxpayers who willfully participate in schemes for the purpose of violating tax laws. These schemes include both domestic and offshore plans that typically include various layers of structures, onshore and offshore, which are meant to give the appearance that the U.S. taxpayer is not the true owner of assets or the true earner of income. Many of these schemes implement complicated structures utilizing entities such as trusts, foreign corporations and foreign partnerships designed for the appearance that a trustee, nominee, non-resident alien or other foreign entity owns assets and is the party for which income is attributable. In these structures, the domestic taxpayer is actually the proper recipient of the income.

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[13] Report, p. 14.
[14] Report, p. 17.

Topping the list of abusive tax scheme victories for IRS CI is the 55-month sentence of the designer of Tax Break 2000 which was marketed through the National Audit Defense Network. The fraud exceeded $36 million, while the intended tax loss to the government was more than $60 million. The scheme falsely promised that the Tax Break 2000 product entitled purchasers to tax credits and deductions under the Americans with Disabilities Act.[15]

E. HIGH-INCOME NON-FILER INVESTIGATIONS

Amazingly, there are high-earning taxpayers who simply stop filing and paying taxes. This phenomenon undermines public confidence and the IRS's ability to administer the tax laws fairly and efficiently. Too many taxpayers have been shocked when they fail to file a tax return that the IRS takes years to finally contact them. The problem for those taxpayers is that if the branch of the IRS who reaches out and touches them is CI, there is a commitment to devoting significant investigative resources. CI is focused on taxpayers who simply refuse to comply with the law.

CI has a category for high-income non-filers. Two examples involve relatively modest unpaid tax amounts of $520,351 and $439,515, respectively. A third case describes a millionaire businessman sentenced to 32 months in prison. The amount of tax loss that was subject to restitution amounted to $7,676,757.[16]

F. EMPLOYMENT TAX FRAUD

Rounding out the legal source tax crimes is employment tax fraud. Employment tax fraud is so damaging because many of the tax evasion cases involve a multiple number of employees. Typical methods of employment tax fraud include pyramiding, employee leasing, payment of employees in cash, false payroll tax returns, and simple failure to file payroll tax returns. Some business owners withhold taxes from employees' paychecks and intentionally fail to remit the taxes to the IRS, while only paying the employees the amount of the net payroll check.

The cases demonstrate the enormity of the payroll tax evasion problem. The sentences began with a low of 30 months in prison to a pair of 78-month sentences. The maximum sentences were two cases with separate 240-month sentences. On the tax loss side, the figures were enormous. The lowest was only $1.5 million. The remaining tax loss amounts were all in excess of $20 million, ranging from $21,442,173 to almost $26 million.[17]

V. CONCLUSION – BYPASS THE IRS CI THREAT BY BEATING THE IRS TO THE PUNCH THROUGH A VOLUNTARY DISCLOSURE

CI continues to commit substantial resources to direct investigative assets committed to legal source cases. With respect to legal source income cases, one of the most powerful tools in

[15] *Id*.
[16] Report, pp. 18-19.
[17] Report, pp. 19-20.

avoiding being part of the IRS statistics is to take advantage of the IRS domestic and offshore voluntary disclosure programs.

Since the inception of the Offshore Voluntary Disclosure Program in fiscal year 2009, there have been more than 48,000 voluntary disclosures from individuals involving offshore accounts who have paid approximately $9.9 billion in taxes, penalties and interest.[18] The IRS rolled out streamline procedures to assist non-willful taxpayers with offshore compliance challenges. The streamline procedure has been utilized by 48,000 taxpayers who have paid approximately $400 million in taxes. Finally, old-fashioned domestic voluntary disclosures remain an extremely powerful tool to combat domestic reporting issues which, with the benefit of hindsight, could be interpreted as fraudulent.

The IRS has collected and mined the data received from the domestic and offshore voluntary disclosure programs. The IRS is using this data to pursue taxpayers who have not properly remediated past errors. Accordingly, despite rumors to the contrary, the IRS CI web continues to expand.

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[18] https://www.irs.gov/uac/newsroom/offshore-voluntary-compliance-efforts-top-10-billion-more-than-100000-taxpayers-come-back-into-compliance

Southwest Royalties: Extracting Taxpayer Opportunities From Texas' "Victory"

There has been no lack of publicity surrounding the Texas Supreme Court's June 2016 holding in *Southwest Royalties, Inc. v. Hegar* that certain extraction equipment used in oil and gas exploration and production operations does not qualify for the manufacturing exemption from Texas sales tax. The Texas Attorney General and Comptroller of Public Accounts (collectively, the "State") have touted the decision as a major win, purportedly saving Texas nearly $4.5 billion.[1]

The Texas Supreme Court denied Southwest Royalties, Inc.'s Motion for Rehearing on October 21, 2016, and as of this writing no legislation has been introduced to alter the decision. So for now, the Supreme Court's holding will stand.

But the holding is not the whole story. What hasn't been as publicized is that the State lost important ground in its ongoing battle over the scope of the manufacturing exemption. The Supreme Court cut back the State's interpretation of the exemption, jeopardizing arguments that the State has been using for years to deny the manufacturing exemption to taxpayers across a broad range of industries. As a result, the State's "win" may ultimately expand the exemption by reinvigorating these previously denied taxpayer positions.

I. Background

In 2009, Southwest Royalties filed a refund claim with the Texas Comptroller of Public Accounts, claiming that equipment and materials (e.g., casing and tubing) used in its oil and gas exploration and production operations from January 1, 1997 to April 30, 2001 qualified for the manufacturing exemption. The Comptroller denied the claim, and Southwest Royalties filed suit. Southwest Royalties claimed that its equipment was exempt under three different provisions of the manufacturing exemption, all of which require the equipment to be "used or consumed" in "the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale."[2]

According to Southwest Royalties, its equipment qualified for the exemption because it processed hydrocarbons by separating them into their component parts. The Comptroller countered that only manufacturing qualifies for the exemption, and that extracting hydrocarbons is not manufacturing. More specifically, the Comptroller argued that "processing" and "fabrication" are not separate bases for granting the exemption, but instead are merely steps in the manufacturing process. Thus, manufacturing must have begun for a taxpayer to claim the exemption, such that extraction equipment—which the Comptroller argued is used prior to manufacturing—could not qualify for the exemption.

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[1] Press Release, Texas Attorney General, Court Unanimously Rules for Texas in Southwest Royalties (June 17, 2016), *available at* https://www.texasattorneygeneral.gov/news/releases/court-unanimously-rules-for-texas-in-southwest-royalties. *But see* The Perryman Group, The Potential Effect of Exempting Downhole Processing Equipment from Taxation on State of Texas Tax Receipts, 10, 15 (2016), *available at* http://web.txbiz.org/External/WCPages/WCWebContent/WebContentPage.aspx?ContentID=1827 (Because "reducing the cost of drilling by implementing a tax exemption leads to [increased] drilling activity," which stimulates economic activity, the net effect of exempting downhole equipment would be an increase in state and local tax collection.).

[2] Tex. Tax Code § 151.318(a)(2), (5), (10) (emphasis added).

On April 12, 2012, the trial court ruled in Southwest Royalties' favor, finding that its equipment processed hydrocarbons because it physically changed hydrocarbons during extraction. But the judge reversed his ruling after the Wall Street Journal published an article stating that "the decision would change 50 years of tax policy" and cost Texas billions of dollars in tax revenue.[3] The judge's new ruling found that Southwest Royalties' equipment did not qualify for the manufacturing exemption because its physical changes to the hydrocarbons were "indirect."[4] Southwest Royalties appealed to the Third Court of Appeals.

The Third Court of Appeals affirmed the district court's ruling, but not its rationale. The Third Court found that the term "processing" was ambiguous, and therefore deferred to the Comptroller's interpretation of the term. That interpretation, as discussed above, is that processing is a stage of manufacturing, that extraction occurs pre-manufacturing, and that extraction therefore could never be "manufacturing." As such, the Third Court effectively denied the exemption to all extraction equipment. Again, Southwest Royalties appealed.

The Texas Supreme Court affirmed, but refused to adopt the Comptroller's broad interpretation of the bounds of the manufacturing exemption. Instead, the Court found that the term "processing" was unambiguous. Because the term "processing" was unambiguous, the Court declined to give deference to the Comptroller's interpretations. In fact, the Court explicitly rejected the Comptroller's argument that "processing" is a step in the "manufacturing" process, finding instead that the legislature intended "processing" to include activities "outside the confines of manufacturing."[5]

Ultimately, the Supreme Court held that Southwest Royalties' equipment did not directly "process" hydrocarbons, and thus did not qualify for the exemption. The Court determined that "processing" means "the application of materials and labor necessary to modify or change characteristics of tangible personal property," and that the taxpayer's casing and tubing simply held the wellbore open so that natural temperature and pressure differences between the formation and the surface could cause physical and chemical changes to the hydrocarbons.[6] In other words, similar to the trial court's ruling, the Supreme Court held that the taxpayer's equipment was only an *indirect* cause of the physical and chemical changes, and therefore the equipment did not satisfy the statute's requirement that the equipment be *directly* used to manufacture, process, or fabricate tangible personal property.

II. Taxpayer Opportunities

The direct fallout from the Supreme Court's decision is that the Comptroller should no longer be able to argue that equipment used in extraction is per se ineligible for the manufacturing exemption. As discussed in more detail below, taxpayers should now have the opportunity to

[3] Tom Fowler, *Texas Warns Drilling Case Would Cost It Billions*, WALL ST. J., Apr. 17, 2012, at A7.
[4] The exemption requires property to be "*directly* used or consumed . . . during the actual manufacturing, processing, or fabrication of tangible personal property." Tex. Tax Code § 151.318(a)(2) (emphasis added). *See, e.g.*, *Sabine Mining Co. v. Strayhorn*, 13-06-330-CV, 2007 WL 2390686 (Tex. App.—Corpus Christi 2007, no pet.) (rejecting manufacturing exemption for draglines used in coal surface mining because draglines do not directly cause a chemical or physical change to coal).
[5] *Southwest Royalties, Inc. v. Hegar*, 500 S.W.3d 400, 406 (Tex. 2016).
[6] *Id.*

demonstrate that extraction equipment is exempt under the Supreme Court's definition of "processing." For example, to the extent newly designed equipment directly causes temperature and pressure changes to hydrocarbons, this equipment might qualify for the exemption.[7]

But a deeper dive into *Southwest Royalties* reveals opportunities for taxpayers in industries outside of exploration and production to expand the manufacturing exemption. For example, taxpayers across industries might now argue that their property is exempt even if it is involved in "pre-manufacturing."

A closer analysis uncovers a second potential taxpayer benefit. The Comptroller has broadly denied the manufacturing exemption for equipment that moves property (including exploration and production equipment) on the basis that it is "transportation" equipment. While there is a statutory basis for the exclusion of some transportation equipment, *Southwest Royalties* may present opportunities for both exploration and production companies and other taxpayers whose equipment moves personal property as it processes or fabricates it to argue that the Comptroller's transportation equipment exclusion has been too broad.

Each of these opportunities is discussed below.

a. Pre-Manufacturing Activities Other than Extraction

While the central argument in *Southwest Royalties* was whether extraction can qualify under the manufacturing exemption, the Supreme Court's decision could apply across industries. As discussed above, the State argued that activities that occur before manufacturing, including extraction, cannot qualify for the manufacturing exemption. But the Supreme Court rejected this narrow view and held that property can be exempt if it is processing (or fabricating), even if manufacturing has not yet begun. Comptroller decisions impacting a variety of industries might have been resolved differently under the *Southwest Royalties* approach. For example:

i. Chemicals

In Texas Comptroller's Hearing 8,012, a taxpayer engaged in a lead recycling operation sought the manufacturing exemption for its ammonia purchases. Most of the lead recovered by the taxpayer was from discarded lead-oxide batteries. In order to recover lead from the batteries, the taxpayer, for environmental reasons, had to use ammonia to neutralize the battery acid. According to the taxpayer, the use of "[a]mmonia [wa]s an absolute requirement. Without it the processing could not begin."[8] Despite this, the administrative law judge ("ALJ") accepted the Comptroller's analysis and denied the exemption, reasoning that the taxpayer's "act of neutralizing sulphuric acid is the initial step before the actual processing of the lead" can begin and "cannot be considered a step in the actual manufacturing process . . . the neutralizing operation is simply a preparatory stage."[9]

[7] The property for which Southwest Royalties was claiming the exemption was used between 1997 and 2001. There have been technological advances in exploration and production equipment in the past two decades, and newer equipment may directly process hydrocarbons, though the old equipment at issue in the case was found not to.
[8] Texas Comptroller's Hearing 8,012 (1977).
[9] *Id.*

ii. Software

In Texas Comptroller's Hearing 102,151, the taxpayer used electronic design ("EDA") software to write, transform, simulate, verify, and debug software code. The software code was later transferred to a semiconductor foundry (taxpayer's submanufacturer) that fabricated silicon semiconductor chips on which the software was embedded. Because of this, the taxpayer argued that the EDA software "caused a direct physical change to the functional structure of the chips."[10] The ALJ—accepting the Comptroller's analysis—denied the manufacturing exemption for EDA software, in part, because "the EDA software tools were used in the analog design and testing in preparation for the actual production of the chips by the foundries."[11]

iii. Heavy Equipment

In Texas Comptroller's Letter 9704455L, the taxpayer sought the manufacturing exemption for a crane it purchased. The crane operated (1) shears that cut scrap metal, and (2) a magnet that moved the cut metal to bins for further processing. The Comptroller denied the exemption, in part, because it deemed these processes to be "in preparation for production."[12]

* * *

The rulings above demonstrate the variety of industries and property to which the Comptroller has denied the manufacturing exemption based on the rationale that the processing activities were pre-manufacturing, despite the fact that the property appeared to have been used in processing as defined by the Supreme Court in *Southwest Royalties*.

b. Transportation

Before Southwest Royalties brought its claim through the court system, it sought a sales tax refund through the Comptroller's administrative process.[13] The Comptroller denied the exemption, citing "arguments that were considered [and rejected] by the Comptroller" in prior hearings.[14] In addition to the pre-manufacturing arguments discussed above, the Comptroller based its denial on a determination "that such equipment is used for transportation and is not exempt."[15] This is typical: the Comptroller's approach when denying exploration and production companies the manufacturing exemption has been declaring that the equipment is involved in both "pre-manufacturing" and "transportation," and is disqualified from the exemption on either ground.[16]

The basis for the transportation denial is that the manufacturing exemption statute does not extend to "intraplant transportation equipment" or other "equipment or supplies used in . . . transportation

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[10] Texas Comptroller's Hearing 102,151 (Feb. 5, 2014).
[11] *Id.*
[12] Texas Comptroller's Letter 9704455L (Apr. 11, 1997).
[13] Texas Comptroller's Hearing 100,619 (Oct. 15, 2009).
[14] *Id.* See, e.g., Texas Comptroller's Hearing 39,936 (2003).
[15] *Id.*
[16] *See, e.g.*, Texas Comptroller's Hearing 40,528 (Apr. 18, 2002) (noting the Comptroller "argues the recompressors at issue are used for transportation. In the alternative, [the Comptroller] argues the recompression activity is an activity 'in preparation for production.'").

activities."[17] Judicial decisions interpreting this language suggest that it is meant merely to avoid an interpretation of the manufacturing exemption that includes entire integrated manufacturing facilities, instead requiring each piece of equipment to be evaluated on a standalone basis.[18] The Comptroller's rules, however, have taken the transportation carveout a step further, indicating, for example, that "intraplant transportation equipment" is taxable even if "manufacturing or processing activities . . . occur during the transportation of product or component parts of the product."[19]

As an example of this aggressive approach to the transportation exclusion, at one time the Comptroller argued that all natural gas compressors were categorically prohibited from claiming the manufacturing exemption after the first time the natural gas was pressurized to a customer's specifications because, in the Comptroller's view, the subsequent compressors did nothing more than facilitate transportation. For example, in Hearing 42,108, the Comptroller argued that compressors powering separators located after the gas was initially pressurized to the customer's specification were taxable.[20] But that argument could not possibly be right, because Section 151.318 of the Texas Tax Code exempts "compressors . . . used to power, supply, support, or control equipment that qualifies for exemption," and separators qualify for the exemption. The Comptroller has since retreated somewhat from this position, allowing the exemption for compressors that power field equipment, but still not allowing the exemption for compressors located on distribution lines or near the wellhead.[21] Yet it has arguably not gone far enough. Indeed, after *Southwest Royalties*, there is an argument that the Comptroller's position on compressors is still too aggressive, and that most or all compressors should be exempt because they change the physical characteristic of natural gas by (for example) pressurizing it and removing water and other compounds, such as sulfur and various hydrocarbons.[22] As the ALJ found in Hearing 42,108, the processing of natural gas is not complete until it is transferred to the customer, and removing contaminants from gas is processing.[23]

Because the Supreme Court determined that Southwest Royalties' down-hole equipment was not "processing," the Court did not reach the Comptroller's additional argument that the equipment was categorically excluded from the manufacturing exemption as "transportation" equipment. It may be telling that the Supreme Court did not address the Comptroller's transportation argument, as a transportation exclusion as robust and clear as the Comptroller asserts would seemingly have been an easy way to decide the case in the Comptroller's favor. If nothing else, the Supreme Court left taxpayers an opening to demonstrate that the Comptroller's interpretation of the exclusion is contrary to the plain meaning of the statute and the legislative intent.

The opportunity *Southwest Royalties* presents for a narrower reading of the "transportation" exclusion will likely be important for exploration and production companies, because even if they

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[17] Tex. Tax Code § 151.318(c)(1), (3).
[18] *See Sabine Mining Co. v.* Sharp, 2007 WL 2390686 (Tex. App.—Corpus Christi 2007, no pet.) (mem. op.) (explaining that the legislature's 1997 amendments to the manufacturing exemption were intended to, among other things, put an end to courts applying the exemption to "integrated" facilities, rather than on an item by item basis).
[19] 34 Tex. Admin. Code § 3.300(c)(5).
[20] Texas Comptroller's Hearing 42,108 (Sept. 17, 2009).
[21] Texas Comptroller's Letter 201509491L (Sept. 30, 2015).
[22] This is in addition to the more obvious argument that the Comptroller can no longer say that wellhead compressors do not qualify for the exemption because extraction is not manufacturing. *See* Part I.
[23] Texas Comptroller's Hearing 42,108 (Sept. 17, 2009).

successfully argue that their extraction equipment performs a processing function, the Comptroller will likely argue (as it has in the past) that the extraction equipment is excluded as transportation equipment. It will also be important to other taxpayers who can argue that their equipment processes product while it moves the product.

At bottom, *Southwest Royalties* may have brought to light a number of historic Comptroller errors in interpreting the manufacturing exemption, the implications of which extend beyond whether property used in extraction can claim the exemption.

Texas Tax Cases to Watch in 2017
By: Bucky Brannen[1] and Alex Pilawski[2]

The past year saw some landmark tax cases issued by the Texas Supreme Court in the area of state and location taxation. First, the Court held that the imposition of a tax on cigarette manufacturers that were not part of the late-1990s settlement agreement with the major tobacco companies did not violate the Equal and Uniform Clause of the Texas Constitution.[3] Later, in *Hallmark*, the Court held that in computing the apportionment factor for franchise tax, a taxpayer is not required to reduce the denominator to the extent total net losses exceed net gains on the sale of an investment or capital asset.[4] Additionally, in a case that affects almost all Texans, the Court described Texas' school finance system as "Byzantine" and noted there was immense room for improvement, but ultimately upheld it as constitutional.[5] Finally, in *Southwest Royalties*, much to the dismay of taxpayers in the oil & gas industry, the Texas Supreme Court held that equipment used in extracting, separating, and bringing hydrocarbons to the surface did not qualify for the manufacturing exemption.[6]

2017 is shaping up to be another interesting year for state taxation issues and is already off to a quick start. On January 6, the Third Court of Appeals issued its much-anticipated substitute opinion in *American Multi-Cinema, Inc. v. Hegar*.[7] While the Court still ruled in favor of the taxpayer in its substitute opinion, it held that the movie theatre's product falls within the definition of "tangible personal property" under § 171.1012(a)(3)(A)(ii)[8] and expressly avoided the issue of whether it also falls within the definition of § 171.2012(a)(3)(A)(i)[9] since the previous determination was dispositive. Thus, the Court significantly narrowed the potentially expansive application of its original opinion.

This article seeks to highlight several of the important cases currently pending before the Texas Supreme Court that may be decided later this year.

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[3] *Hegar v. Tex. Small Tobacco Coal.*, No. 14-0747, 59 Tex. Sup. Ct. J. 534, 2016 Tex. LEXIS 228 (Tex. Apr. 1, 2016).

[4] *Hallmark Mktg. Co., LLC v. Hegar*, 488 S.W.3d 795, 796 (Tex. April 15, 2016).

[5] *Morath v. Tex. Taxpayer & Student Fairness Coal.*, 490 S.W.3d 826, 833 (Tex. May 13, 2016).

[6] *Sw. Royalties, Inc. v. Hegar*, No. 14-0743, 59 Tex. Sup. Ct. J. 1316, 2016 Tex. LEXIS 508 (Tex. June 17, 2016).

[7] *Am. Multi–Cinema, Inc. v. Hegar*, 03-14-00397-CV, 2017 Tex. App. LEXIS 85 (Tex. App.—Austin Jan. 6, 2017, no. pet. h.).

[8] All § references are to the Texas Tax Code.

[9] Defining "tangible personal property" to mean "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."

***Graphic Packaging, Inc. v. Hegar*[10]**

At issue in *Graphic Packaging* is whether a taxpayer may use the three-factor apportionment formula provided for under the Multi-State Tax Compact in computing its Texas franchise tax rather than the single-factor formula set forth in the § 171.106.

The trial court ruled in favor of the Comptroller, and was affirmed by the Third Court of Appeals. The Court of Appeals held that the franchise tax is not an income tax and thus the three-factor apportionment formula under the Compact is not applicable. In deciding the franchise tax is not an income tax, the Court stated that none of the alternative ways of computing the franchise tax result in taxing net income.

A decision in favor of the taxpayer would have a dramatic impact on franchise tax for many taxpayers, particularly those with a multistate presence. Additionally, a large number of taxpayer have already filed refund claims on the basis of this case.

The Texas Supreme Court has ordered briefing on the merits. Briefing should conclude in the early part of this year.

***ETC Marketing Ltd. v. Harris County Appraisal District*[11]**

ETC Marketing is an important property tax case with Commerce Clause implications. At issue is whether natural gas in an interstate pipeline system becomes subject to property tax if stored for some period of time in an underground reservoir in Texas, or whether it retains its interstate commerce exemption.

The trial court granted summary judgment for the Appraisal District, and the First Court of Appeals affirmed. The Court held that the natural gas was stored in Harris County for more than a temporary period of time, and Harris County's imposition of property taxes satisfied the four prongs of *Complete Auto*.[12]

In its briefings to the Supreme Court of Texas, ETC argues that it has no control over its natural gas once it enters interstate pipeline system—a system managed by a third party. Because it has no control, ETC does not decide whether the gas is stored in the underground reservoir. Further, ETC argues that any storage is strictly temporary while the gas awaits delivery to customers.

The Appraisal District responds that the natural gas is not in transit to customers; rather, it is stored indefinitely until ETC determines when and where to sell it.

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[10] 471 S.W.3d 138 (Tex. App.—Austin, 2015, pet. filed). This matter is pending before the Texas Supreme Court as Cause No. 15-0696.

[11] 476 S.W.3d 501 (Tex. App.—Houston [1st Dist.] 2015, pet. granted). This matter is pending before the Texas Supreme Court as Cause No. 15-0687.

[12] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

In oral arguments, the Supreme Court Justices focused their questions on the reasons for storage—more specifically, whether storage was (i) a necessary and essential component of interstate transport, or (ii) for more than a temporary period with a business purpose beyond merely enabling transport.

The Court granted review on September 2, 2016 and heard oral arguments on Dec 6, 2016. An opinion is anticipated later this year.

***EXLP Leasing LLC & EES Leasing LLC v. Ward County Appraisal District*[13]**

Primarily at issue in *EXLP Leasing* is whether the Texas Legislature can constitutionally separate types of property into different classes when prescribing special appraisal methods for property tax valuation. While the majority of tangible personal property is appraised in Texas on the basis of its January 1 market value, Texas utilizes special appraisal methods for certain types of property. The statute at issue in *EXLP Leasing*, § 23.1241, requires heavy-equipment inventories (here, natural-gas compressors) to be appraised on the basis of prior-year sales. This issue concerns numerous taxpayers and appraisal districts across Texas, as there are hundreds of current lawsuits on-hold—each awaiting the Supreme Court's decision in this case.

Two Courts of Appeals have issued opinions on this issue. The Eighth Court of Appeals ruled in favor of EXLP, reversing "[t]he portion of the trial court's judgment declaring Sections 23.1241 and 23.1242 to be unconstitutional," and rendering judgment "that these two statutes are not unconstitutional as applied."[14] The Fourteenth Court of Appeals reversed the trial court judgment that the statute was unconstitutional, but, instead of rendering judgment for EXLP, remanded the case to the district court to determine whether the statute "create[s] a reasonable method of appraising the market value of" the inventory.[15]

EXLP cites the Texas Constitution, which states, "All real property and tangible personal property in this State... shall be taxed in proportion to its value, *which shall be ascertained as may be provided by law*."[16] EXLP argues that this broad grant of power to the Legislature explains why the Supreme Court of Texas has never invalidated a valuation statute. EXLP argues for deference to the Legislature, which has refined § 23.1241 over the years in order to solve administrative and compliance problems that have arisen in attempting to value heavy-equipment inventories.

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[13] 476 S.W.3d 752 (Tex. App.—El Paso 2015, pet. filed); *EXLP Leasing LLC v. Loving County Appraisal Dist.*, 478 S.W.3d 790 (Tex. App.—El Paso 2015, pet. filed); *EXLP Leasing, LLC v. Galveston Cent. Appraisal Dist.*, 475 S.W.3d 421 (Tex. App.—Houston [14th Dist.] 2015, pet. filed); *Midcon Compression, L.L.C. v. Reeves County Appraisal Dist.*, 478 S.W.3d 804 (Tex. App.—El Paso 2015, pet. filed); *Valerus Compression Servs v. Reeves County Appraisal Dist.*, 478 S.W.3d 20 (Tex. App.—El Paso 2015, pet. filed).

The Supreme Court of Texas has consolidated these five cases on appeal. These matters are pending before the Texas Supreme Court as Cause Nos. 15-0683, 15-0965, 15-0969, 15-0970, and 15-0971.

[14] 476 S.W.3d at 763.

[15] 475 S.W.3d at 428.

[16] Tex. Const. art. VIII, § 1(b) (emphasis added).

The Appraisal District argues that Texas courts have interpreted the Constitution's mandate—that property "be taxed in proportion to its value"—to require a willing-buyer, willing-seller standard for all property. The Appraisal District further alleges that § 23.1241 is unconstitutional because it does not achieve equal and uniform taxation.[17]

Heavy-equipment dealers are not the only taxpayers potentially impacted by this case. A victory for the Appraisal District could result in the invalidation of several other special appraisal methods.[18]

The Texas Supreme Court has ordered consolidated briefing on the merits. The initial briefs were filed on November 1, 2016. Response briefs were filed on December 22, 2016, and briefing is set to conclude with Reply briefs currently due on February 6, 2017.

Valero Refining v. Galveston Central Appraisal District[19]

Valero Refining concerns whether Valero, in comparing its facilities to others in an equal and uniform analysis, can exclude the value of pollution control equipment, which is largely non-taxable in Texas.[20]

Valero's position is that because the Appraisal District separated its facility into different account numbers, Valero should be able to contest some of those accounts but not others. In other words, Valero sought to apply equal and uniform analysis to certain portions of its refinery as compared to the corresponding portions of nearby BP and Marathon refineries. Valero's experts compared the facilities using valuation metrics based on the capacity and complexity of each refinery as compared to their valuations (after excluding the pollution control equipment of each refinery).

The Appraisal District argues that an equal and uniform comparison must consider each facility in its entirety—including all account numbers associated with the facility.

The trial court ruled in favor of Valero, reducing the equal and uniform value by nearly $200 million. But the Fourteenth Court of Appeals reversed and remanded, ruling that whether pollution-control equipment should be excluded is a question of fact, and the evidence was legally insufficient to support exclusion.

The primary issue on appeal thus appears to be whether this is an issue of fact or law. Valero argues that as a practical matter, when an appraisal district separates property into several different account numbers, taxpayers are not required to guess which accounts must be bundled together—especially in light of the fact that these accounts may pertain to large, complex industrial facilities

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[17] *See id.* § 1(a).

[18] TEX. TAX CODE, Title 1, Chapter 23, Subchapter B requires special appraisal methods for several different classes of property, including motor vehicle inventories, temporary production aircraft, and vessel inventory.

[19] 463 S.W.3d 177 (Tex. App.—Houston [14th Dist.] 2015, pet. granted). This matter is pending before the Texas Supreme Court as Cause No. 15-0492.

[20] There are also important evidentiary disputes at issue that are beyond the scope of this article.

that contain property owned by third parties. And as a legal matter, it cites several cases that appear to support partitioning larger facilities for purposes of valuation.

The Appraisal District responds that pollution-control equipment is integral to the refinery, would assuredly be included in any sale of the refinery, and therefore should be included in an equal and uniform valuation.

Briefing on the merits concluded in April 2016. The Court granted the Petitions for Review on September 2, 2016. The Court heard oral arguments on November 9, 2016.

***Allstate Insurance Co. v. Hegar*[21]**

Allstate concerns whether and under what circumstances temporary staffing services are excluded from Texas sales tax as temporary employee services under § 151.057(2). Allstate Insurance subcontracted with a third party, Pilot Catastrophe Services, Inc., to supplement Allstate's existing staff of claims adjusters, commonly following a weather event that generated a large volume of claims.

Allstate argued these staffing services were excluded from Texas sales tax under § 151.057(2). This section excludes from sales tax, services performed by employees of temporary employment services for an employer to temporarily supplement their existing work force. This provision requires (i) the service to be normally performed by the employer's own employees, (ii) the employer to provide all supplies and equipment necessary, and (iii) the temporary employees to be under the supervision of the employer.

The Comptroller took issue with whether these adjusters were "temporary," claiming the adjusters did not qualify as temporary employees since they were provided by Pilot to Allstate on a continuous and ongoing basis. In support of this argument, the Comptroller noted that there was at least one Pilot employee, and usually more, providing adjusting services to Allstate on any given day throughout the period at issue.

The Court disagreed with the Comptroller's "holistic" view regarding whether the services were temporary in nature and held that the exclusion must be analyzed on an individual employee basis. Applying this standard, the Court determined that Pilot provided each individual adjuster to Allstate on a temporary basis.

While the Court held that several of the adjusters qualified for the exclusion, the Court ruled against Allstate regarding other adjusters for which Allstate did not provide all necessary equipment. A requirement of the § 151.057(2) exclusion is that the employer must provide "all supplies and equipment necessary." Allstate's agreement with Pilot required Pilot's adjusters to have "electronic voice mail, cellular telephones and laptop computers at the time they arrive at a site to provide Adjusting Services to Allstate." Since the contract required the provision of these items, the Court determined them to be "necessary" to the performance of the adjusting services.

[21] 484 S.W.3d 611 (Tex. App.—Austin 2016, pet. filed).

Allstate conceded that it did not provide this equipment to these adjusters. Therefore, the Court denied the exclusion for such adjusters.

This case has significant implications not only for the insurance industry but also for other industries that utilize temporary employment services to supplement their existing workforce. The Court's method of determining the temporary nature on an individual-employee basis is a departure from the Comptroller's historically "holistic" approach and certainly more favorable to taxpayers.

The Texas Supreme Court has ordered briefing on the merits. Briefing is expected to conclude in the early part of this year.

***Fitness International, LLC v. Hegar*[22]**

At issue in *Fitness International* is whether purchases by health clubs of tangible personal property for use by club members qualifies for the sale-for-resale exemption. The taxpayer, Fitness International, owns and operates health clubs in Texas. It grants access to use its facilities and amenities through the sales of memberships.

The trial court granted Fitness' claim in part and denied it in part. The claim was granted as to purchases of towels, basketballs, and personal sanitation consumables; but denied with respect to exercise machines, weight racks, scales, and promotional flyers. The Comptroller withdrew his appeal with respect to the items that were deemed exempt; however, he noted that he disagreed with the trial court's determination. Thus, only the denied items were at issue on appeal.

Fitness argued that its purchases met the exemption's requirements because members paid the membership fee to "rent" the items, and such rental is a sale under § 151.005(2), or the items were "transferred" to members. Fitness also claimed that it did not need to show that it transferred care, custody, and control to the guests because it did not use the items to "perform" services.

The Court rejected Fitness' arguments and held that the equipment was not purchased for the purpose of reselling it, transferring it, or offering it for lease or rental. The Court also noted that the membership agreements could not be reasonably construed as leases or rental agreements and that making the equipment available to members while at the gym did not equate to transferring possession. The Court did not address Fitness' arguments that it was not required to show care, custody, and control was transferred, since it concluded that Fitness did not acquire the items for the purpose of reselling or transferring them.

If Fitness prevails in this matter, it would broaden the application of the sale-for-resale exemption. This could especially affect taxpayers who purchase equipment for use in connection with the provision of taxable services.

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[22] 03-15-00534-CV, 2016 Tex. App. LEXIS 6337 (Tex. App.—Austin June 16, 2016, pet. filed). This matter is pending before the Texas Supreme Court as Cause No. 16-0237.

Fitness' filed its Petition for Review on August 31, 2016. The Court has not ordered full briefing or agreed to hear the case on its merits.

The New Issue Price Regulations: The Good, the Bad and the Ugly

Victoria Ozimek and Brian Teaff

The foregoing article was originally published in *The Bond Buyer*.

Late last year, the Treasury Department released final Treasury Regulations (the "New Regulations") relating to the "issue price" of tax-exempt bonds, effective for bonds sold after June 7, 2017. Because the changes imposed by the New Regulations generally are more palatable than versions proposed in 2013 and 2015, the initial reaction of many in the municipal bond industry - including us - was a collective sigh of relief. Although this initial reaction has not fully faded, a deeper dive into the New Regulations has resulted in a list of questions that need to be considered. Promising a free lunch (and proving that there is, in fact, no such thing), we have spent the last few weeks meeting with various players in the municipal bond market, including issuers, underwriters, and financial advisors, to discuss the New Regulations and to get reactions based on their respective viewpoints. While a detailed summary of the entirety of the discussions is beyond the scope of this article, we boiled down the salient points into the observations that follow.

The Good: A More Inclusive "Public"

Under both the current issue price Treasury Regulations (the "Current Regulations") and the New Regulations, the general rule is that the issue price of bonds issued for money is the first price at which a substantial amount (i.e. 10 percent) of the bonds is sold to the public (the "General Rule"). Under the Current Regulations, many bond counsel have been reticent to consider a sale to, for example, an unrelated broker-dealer as a sale to the "public." The New Regulations set forth a new definition of "public," which excludes only an underwriter or a related party thereto. An "underwriter," in turn, is defined under the New Regulations as any person who agrees pursuant to a written contract with the issuer or with the lead underwriter to participate in the initial sale of bonds to the public or has a written contract with any such person directly or indirectly to participate in the initial sale of bonds to the public (e.g., a retail distribution agreement).

Bankers have immediately zeroed in on the definitions of "public" and "underwriter" under the New Regulations. While future experience may color the interpretation of these definitions, the plain language appears to permit the sale of at least 10 percent of the bonds to non-underwriter broker-dealers to be sufficient to set the issue price, even if it is expected that such broker-dealers may immediately resell the bond to retail buyers at higher prices. The consensus of the bankers we spoke with is that this plain reading of these definitions in the New Regulations makes the General Rule easier to meet and "The Bad" discussed below a bit easier to swallow.

The Bad: Change May Come at an (Issue) Price

Under the Current Regulations, if the General Rule is not met on the sale date of the bonds, issue price may be established on the sale date solely on the basis of the underwriter's reasonable expectations regarding the initial offering price of the bonds. The New Regulations, however, only allow reliance on reasonable expectations under two "special rules" – the "Hold-the-Offering-Price Rule" and the "Competitive Sale Rule."

Under the Hold-the-Offering-Price Rule, an issuer may rely on reasonable expectations as long as certain requirements are met, chief among which is that each underwriter must agree in writing not to sell bonds at a price that is higher than the initial offering price for five business days after the sale date or until 10 percent of the bonds are sold, if earlier. The Competitive Sale Rule allows reliance on reasonable expectations to establish issue price for competitively-bid deals as long as the offering meets the definition of a "competitive sale," which requires, among other things, that at least three bids have been received. Thus, if fewer than three bids are received, issue price must be established using the General Rule or the Hold-the-Offering-Price Rule.

Pointing to market risk and the potential sequestration of capital, the underwriters we spoke with expressed a strong preference to avoid the Hold-the-Offering-Price Rule and "wait it out" until the General Rule is met, even if that means the issue price will not be established until after the sale date (or even the issue date). However, there are certain types of deals – advance refundings and private activity bonds come to mind – in which the need for issue price certainty as of the sale date (and certainly by the issue date) will override the preference to "wait it out." In these cases, one must wonder whether the desire to avoid the Hold-the-Offering-Price Rule will result in a pricing of the bonds at lower initial offer prices so as to ensure that the General Rule will be met quickly, which in turn begs the question of whether the stated policy objective of ensuring that an issuer is getting the full benefit of its debt offering will be realized.

The Ugly (Details): Decisions, Documentation and Diligence

Turning to where the devil resides, market participants must also deal with the details. As the June 7 effective date approaches, an issuer must decide whether it is comfortable "waiting it out" or whether it will require an underwriter to agree to the Hold-the-Offering-Price Rule. In addition, from a documentation perspective, the New Regulations will impact more than just issue price certificates. For example, documents prepared in anticipation of a competitively bid deal must now address the possibility that it may not qualify as a "competitive sale" because three bids are not received. Additionally, the potential for the issue price to be established after the sale date could cause awkward results, such as the "issue price" not matching the "sale proceeds" received by the issuer. Another item to be sorted out is the type and availability of documentation that should be requested and/or retained by issuers and underwriters to demonstrate diligence and compliance in the establishment of issue price so as to be prepared for an audit of the issue that, if sufficient documentation is not provided, has the potential to lead to a redetermination of the issue price and the imposition of penalties against an underwriter. Details such as these will beg for attention as the industry further considers the New Regulations.

Concluding Thoughts

To the Internal Revenue Service's credit, the New Regulations take into account the comments of market participants and respond with significant adjustments to the regulations proposed in 2013 and 2015. After all, market participants no longer face the threat of the "25% of actual sales" or a "hold-the-offering-price-until-closing" rules previously proposed. Nevertheless, now is the time for market participants to put our heads together to address the changes in the New Regulations and consider their impact on transactions, as June 7 will be here sooner than we know it.

Victoria Ozimek is a member of Bracewell LLP's Public Finance practice in Austin, and Brian Teaff is a member its Public Finance practice in Houston.

State Bar of Texas
19th Annual International Tax Symposium

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

TAX SECTION
STATE BAR OF TEXAS

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
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.

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
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 OVDP and offshore disclosure options.

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
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.

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)
This presentation will cover the international structuring of investment in Mexico energy, with consideration of bilateral investment treaties and income tax treaties.

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
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.

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
This session will cover recent updates to transfer pricing and Country-By-Country Reporting on IRS Form 8975.

2:45-3:30 Structuring Inbound Investments into the U.S. [.75 CLE/1.0 CPE]
Willie Hornberger, Jackson Walker, Dallas, TX
This session will cover structuring cross-border acquisitions and dispositions of U.S. and non-U.S. entities.

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
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.

4:15-5:00 Current Developments in International Estate Planning [0.75 CLE/0.5 CPE]
John Strohmeyer, Crady Jewett McCulley, Houston, TX
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.

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:
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- *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:
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- *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:
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- ***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)

  5 4 3 2 1

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

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Comments:

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GENERAL COMMENTS:

1. The quality of my lunch experience was:

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Comments:

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2. The meeting facility was:

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

Comments:

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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.

- o K-1 Disclosures for International Tax Items and Issues.
- o International Value Added Tax (VAT) for U.S. Businesses.
- o A Short Guide to Understanding Foreign Reporting Issues.
- o Pre-Arrival Tax Planning.
- o Accounting for Foreign Real Estate Holdings by U.S. Persons.
- o FIRPTA Withholding and Other Complications on the Sale of Real Estate.
- o Outbound U.S. Income Tax Considerations
- o Understanding Form 8621
- o Divorce Across International Borders.
- o The Portfolio Interest Exception
- o Dealing With International Clients: When It Goes From Civil To Criminal.
- o Cross-Border Tax: Canada/U.S.
- o Cross-Border Tax: Mexico/U.S.
- o U.S. Taxation of Foreign Retirement and Pension Plans.
- o FATCA and the Common Reporting Standard.
- o 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.
Reinhart Boerner Van Deuren s.c.
rmisey@reinhartlaw.com
312-207-5466; 414-298-8135

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]

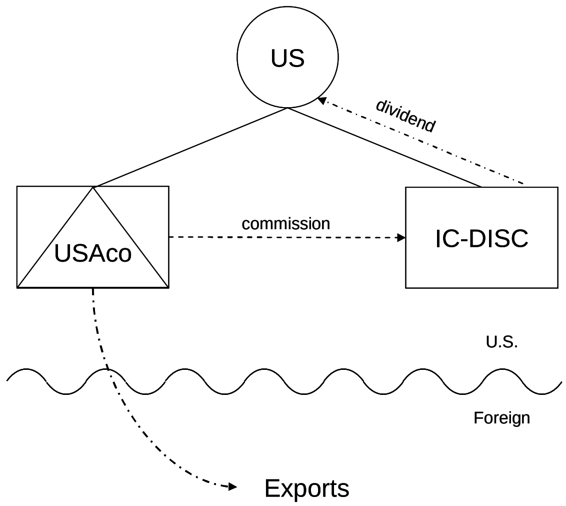
II. THE TESTS TO QUALIFY AS AN IC-DISC

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]

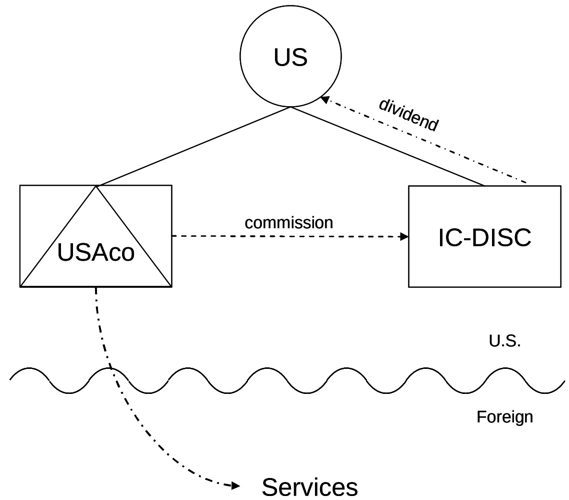
1. Qualified export receipts include gross receipts from sales of export property, rents for the use of export property outside the United States, services related to export sales, engineering or architectural services for construction projects located abroad, and commissions thereon.

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.



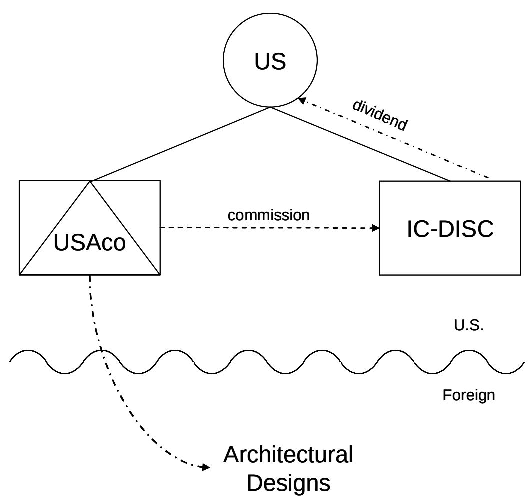
2. Services related to export sales include, but are not limited to, warranty services, maintenance services, repair services, installation services, and even some transportation services.

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.

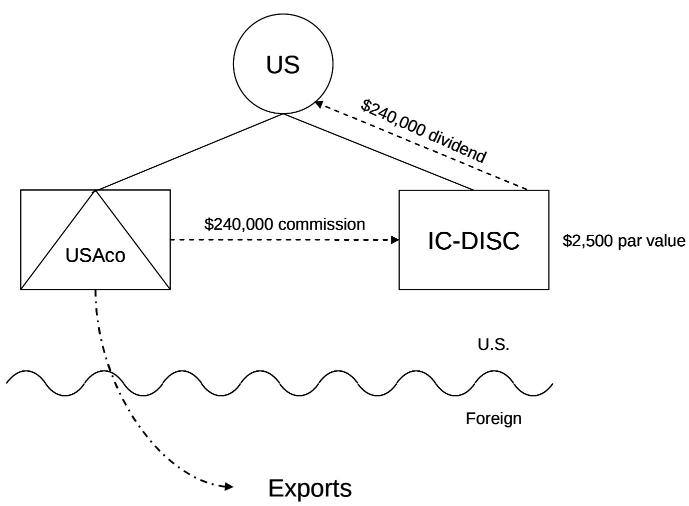


C. The qualified export assets test states that 95% of the assets of the IC-DISC must be qualified export assets.[12]

1. Qualified export assets include accounts receivable, temporary investments, export property, and loans to producers.[13]

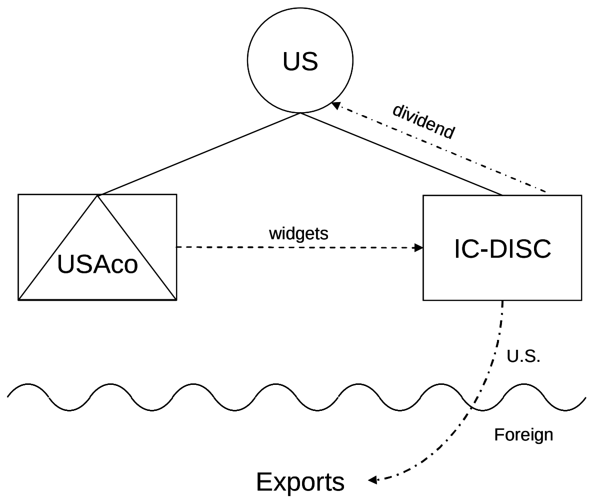
2. Temporary investments must be reasonably necessary to meet the requirements of the IC-DISC and include working capital. For a simply-structured, commission-based IC-DISC, the qualified export assets would typically include the $2,500 of cash paid in as par value for the stock as working capital.

   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. <u>The Manufacturing Requirement</u>.

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.

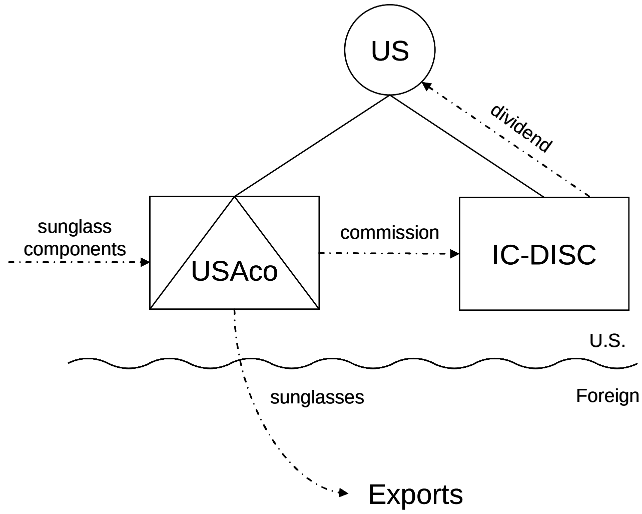
5. The case law is somewhat vague regarding what is generally considered to constitute manufacturing.

(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.

<u>Example 6</u>: 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 <u>only if</u> this process is generally considered to constitute manufacturing.



C. <u>The Destination Requirement</u>.

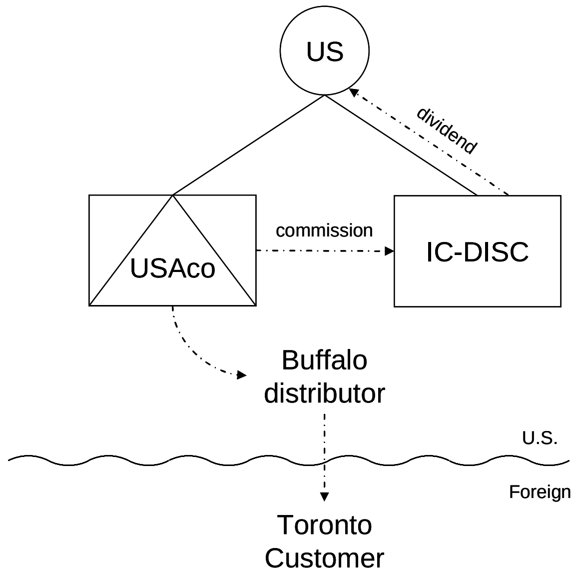
1. The export property must satisfy a destination test, which requires being held for sale, lease or rental in the ordinary course of business for direct use, disposition or consumption outside the United States.[17]

   (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.

   <u>Example 7</u>: 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.



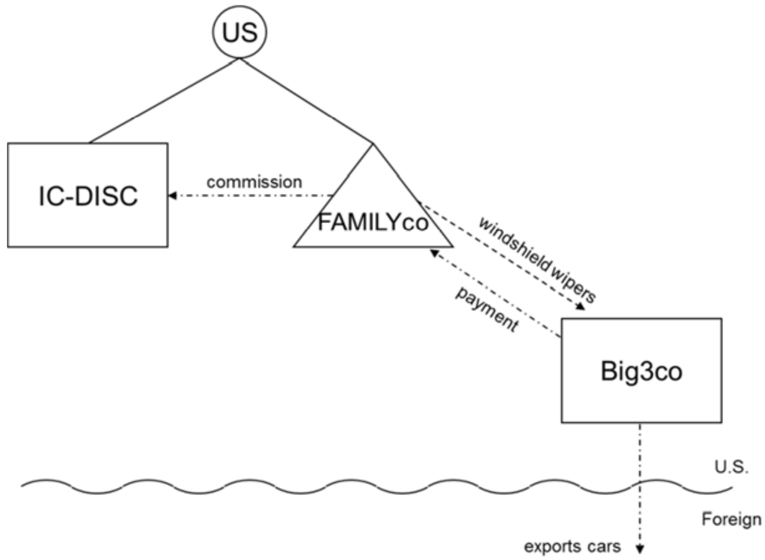
(a) The purchasers of an exporter's product will have to provide the exporter with information showing that the product was exported and, if the domestic purchasers cooperate, the IC-DISC can benefit from these sales.

(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.

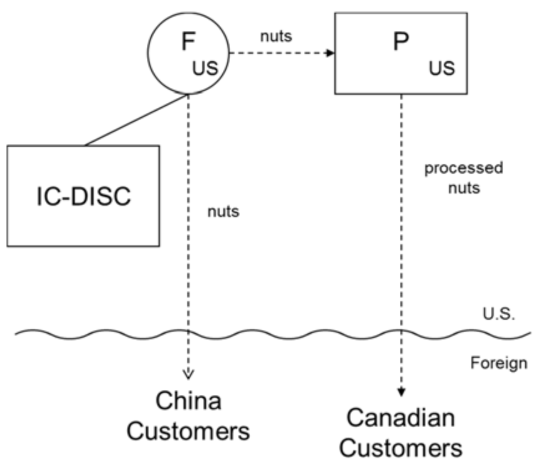
3. At the same time, seemingly export sales could be domestic sales.

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

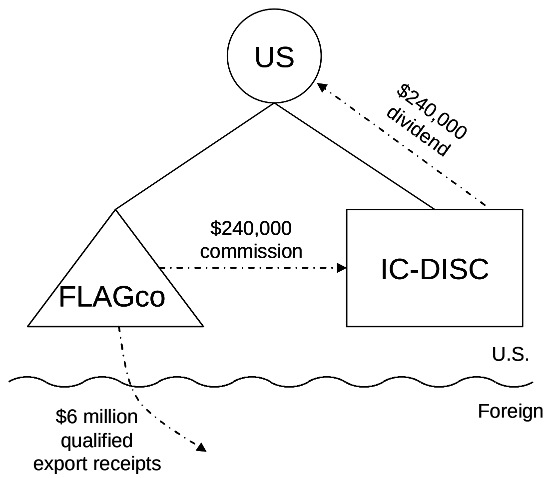
3. the arm's length amount determined under the transfer pricing principles of section 482.[23]

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.

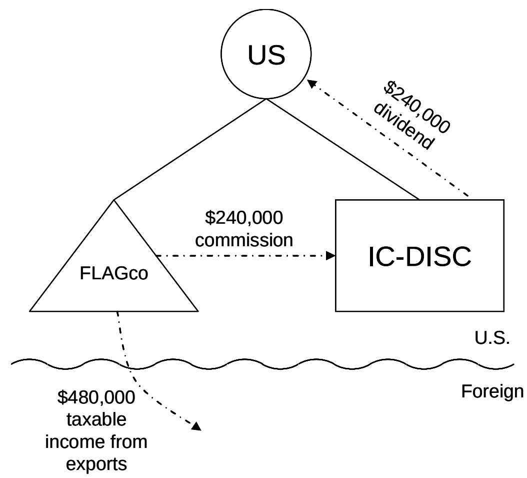
Example 10: Betsy Ross, a U.S. citizen owns FLAGco, a single-member LLC that is disregarded for U.S. tax purposes. FLAGco has qualifying export sales of $6 million of flags through its IC-DISC as its only gross receipts. Using 4% of the qualified export receipts method, FLAGco will deduct a commission 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.

<u>Example 11</u>: 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:

	Gross receipts	*Combined taxable income*	*Net pre-tax margin*
Beer	$ 5,000,000	$1,000,000	20%
Wine	$ 5,000,000	$ 200,000	4%
Total export sales	$10,000,000	$1,200,000	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.

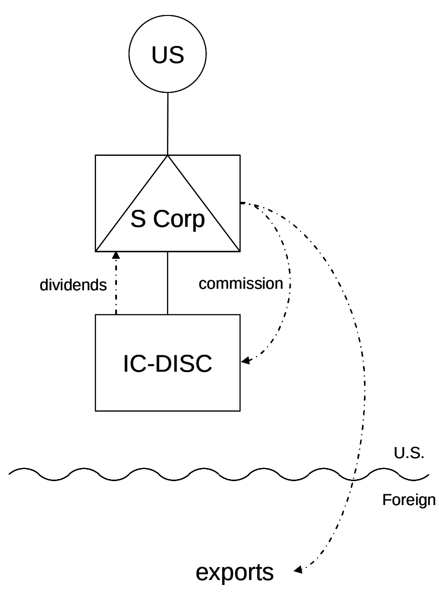
2. As discussed above, combined taxable income equals the excess of qualified export receipts over the total costs of the exporter, which includes deductions that are definitely related to export sales (e.g., cost of goods sold) and a ratable portion of any deductions that are not definitely related 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]

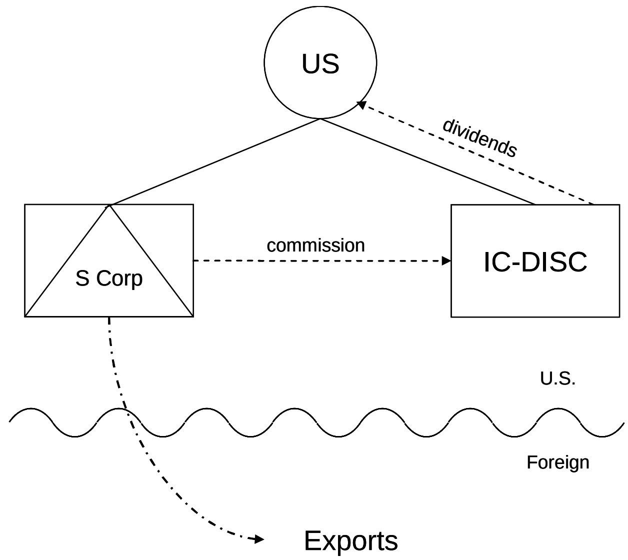
VI. STRUCTURING THE IC-DISC

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.

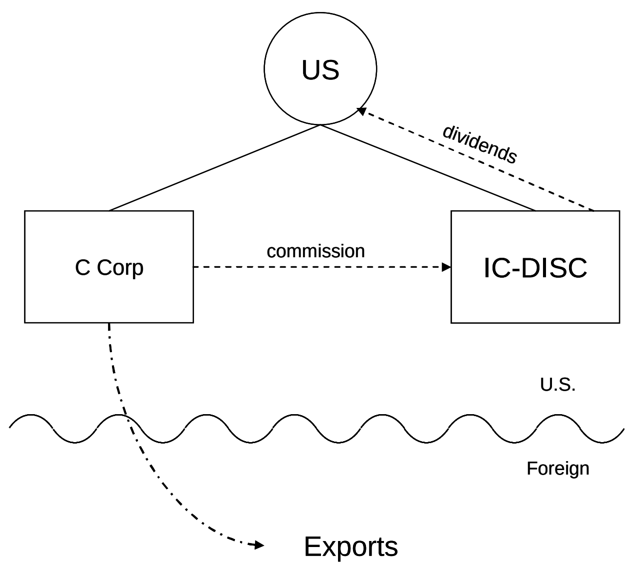


2. IC-DISC as a brother-sister entity of an S corporation or another flow-through entity.



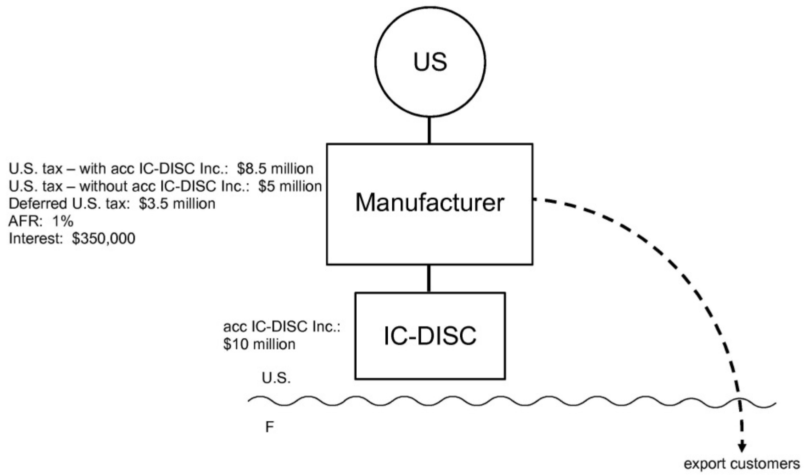
B. An IC-DISC should only be a brother-sister entity of a C corporation.

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

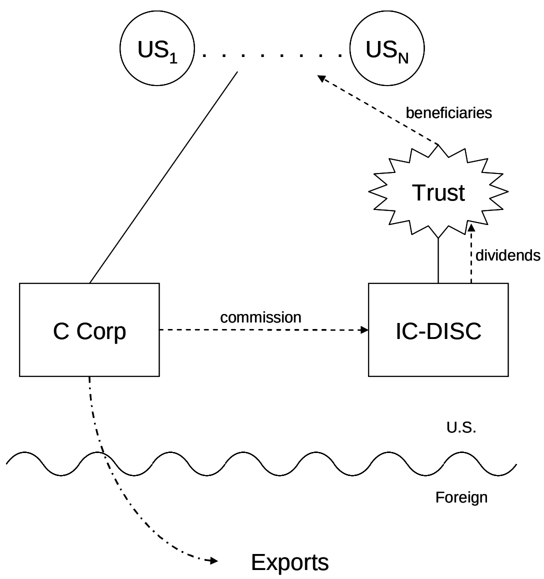


2. An IC-DISC should not be the subsidiary of a C corporation because the C corporation is not entitled to a dividends received deduction when receiving the dividend from the IC-DISC.[36]

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



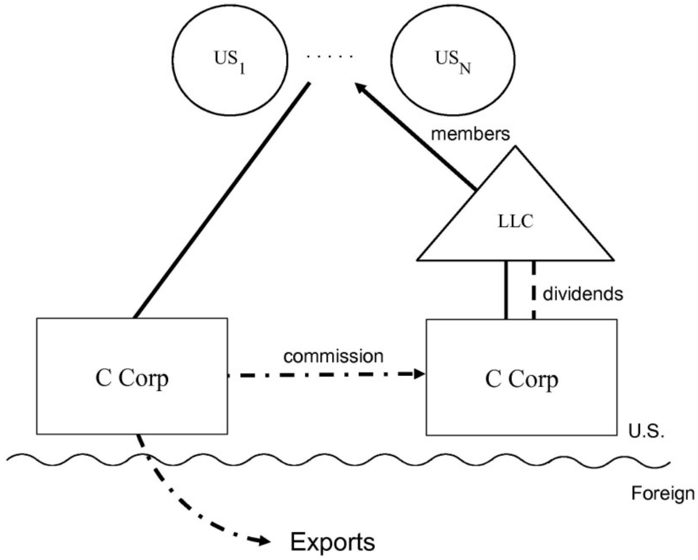
4. If shares of a C corporation are commonly sold, a trust could own the shares of the IC-DISC.



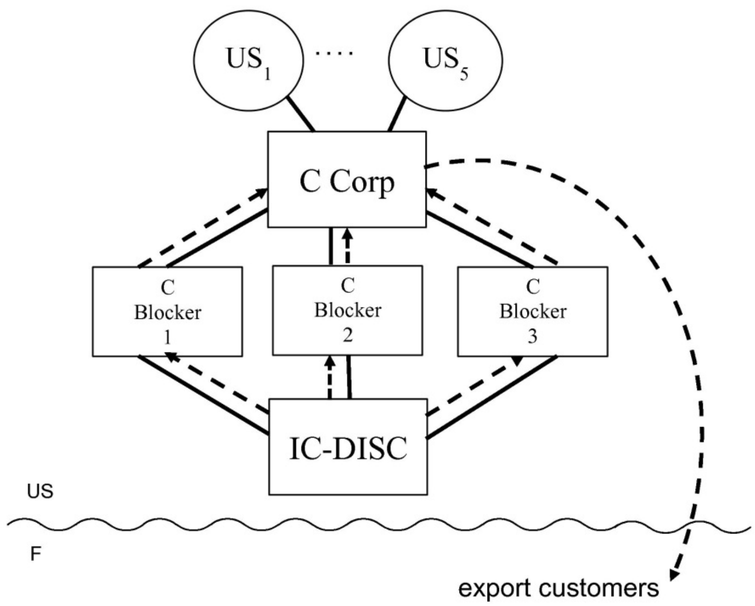
(a) The beneficiaries of the trust would be the owners of the C corporation's shares.

(b) This structure would avoid changing the ownership percentage of the IC-DISC shares every time ownership of the C corporation's shares change.

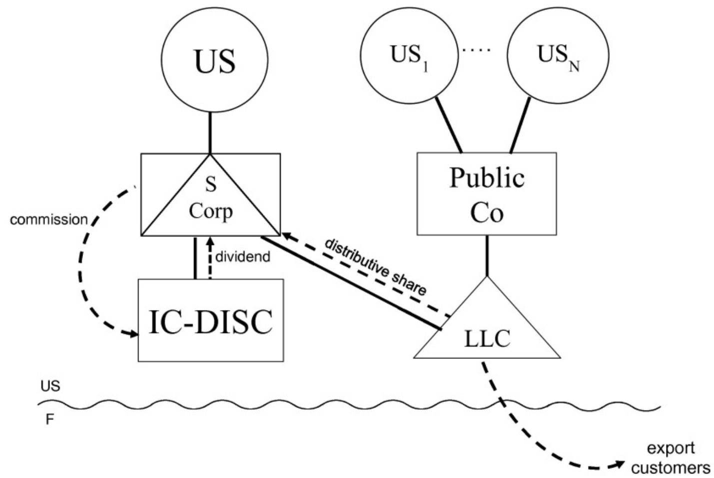
5. LLC ownership also works but is not as easy to draft.



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.

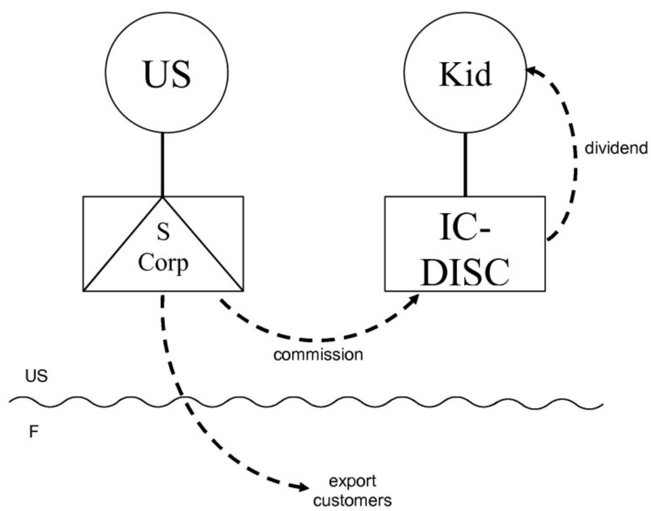


7. An S corporation (or another flow-through entity, such as an LLC), can use an IC-DISC when entering a joint venture with a public company.

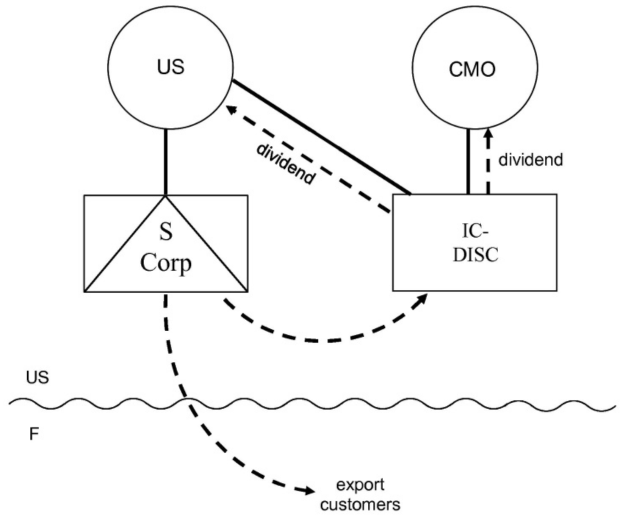


C. Provision of IC-DISC shares to someone who is not currently an owner of the exporter.

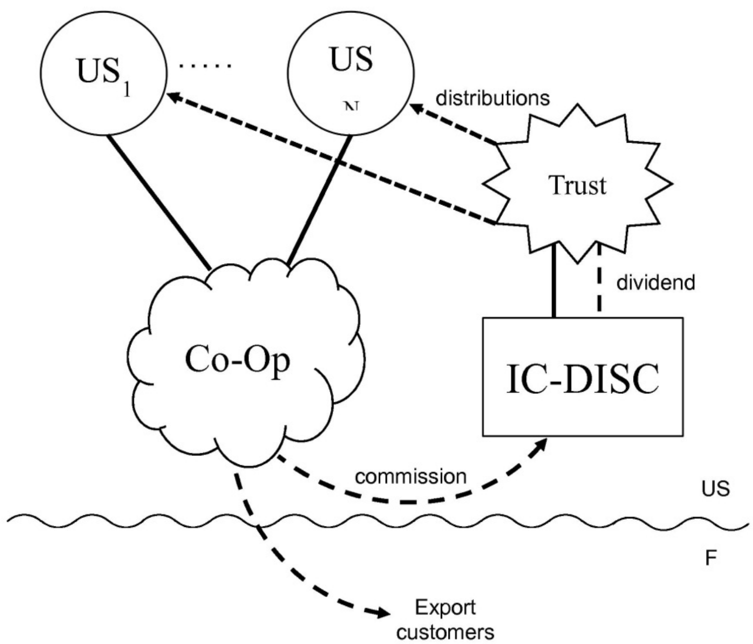
1. Does providing IC-DISC shares to a family member result in gift tax implications?



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

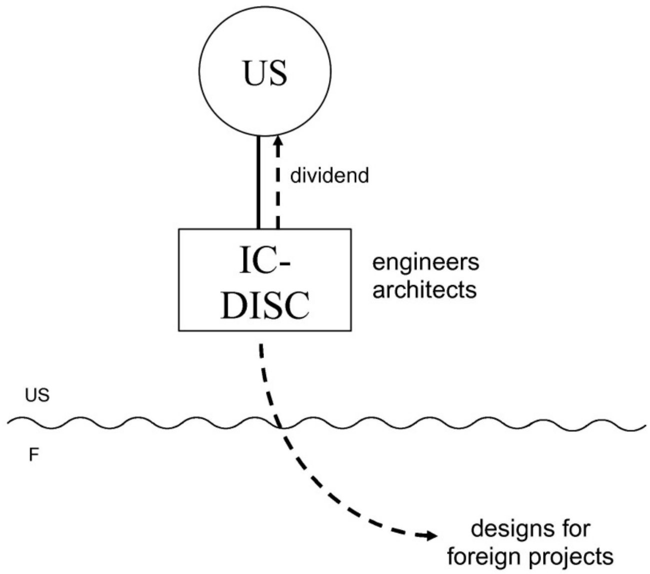


D. IC-DISCs can turn patronage dividends (taxed at ordinary rates) into qualified dividends.

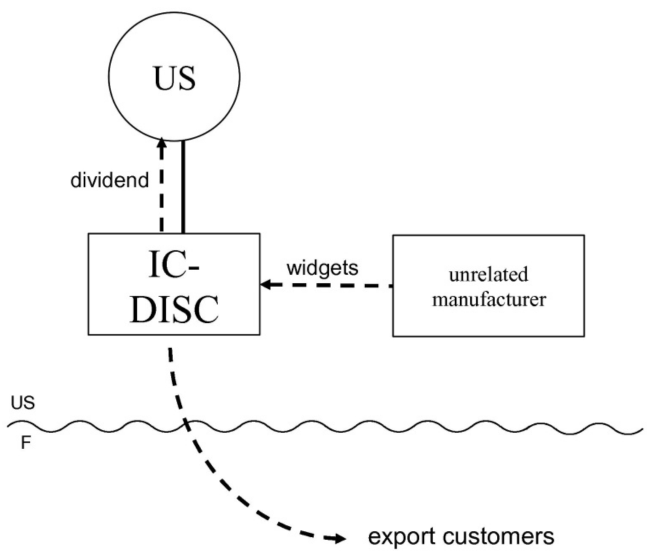


E. Use of only an IC-DISC without another entity.

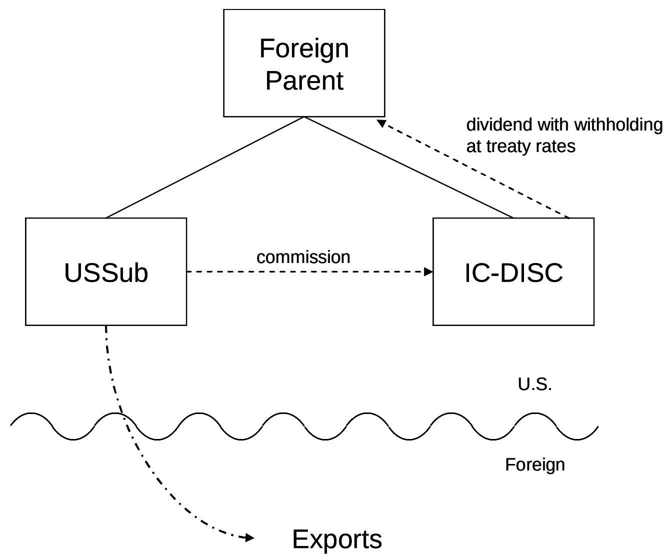
1. Architects and engineers providing designs for foreign projects can all be in one IC-DISC.



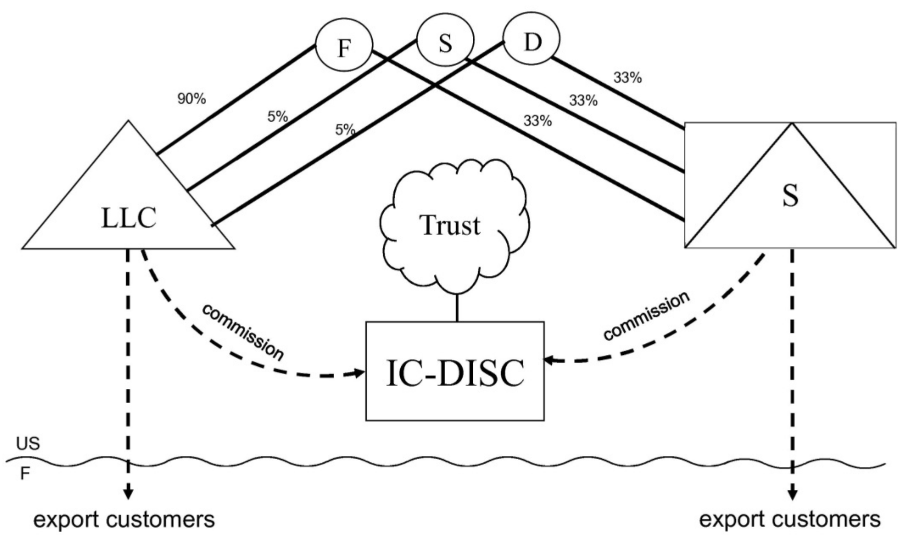
2. Because an IC-DISC cannot manufacture product, a pure distributor that merely exports can capture the entire benefit of an IC-DISC.



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

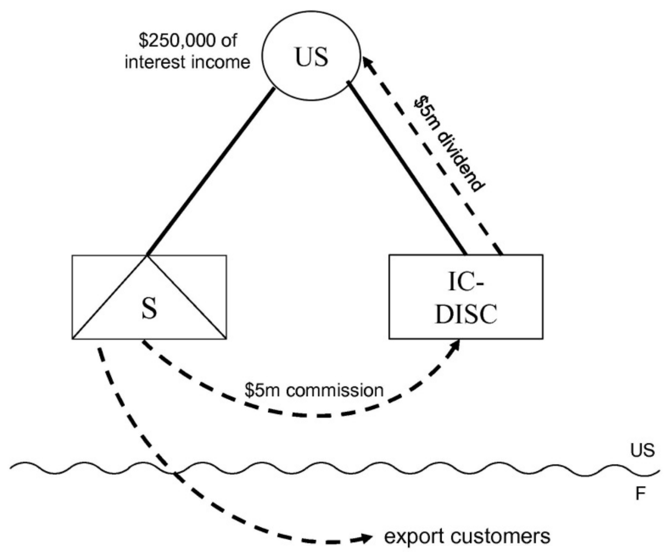


G. An IC-DISC can be used with a trust to capture the benefits of two related exporting entities that have varying ownership interests.

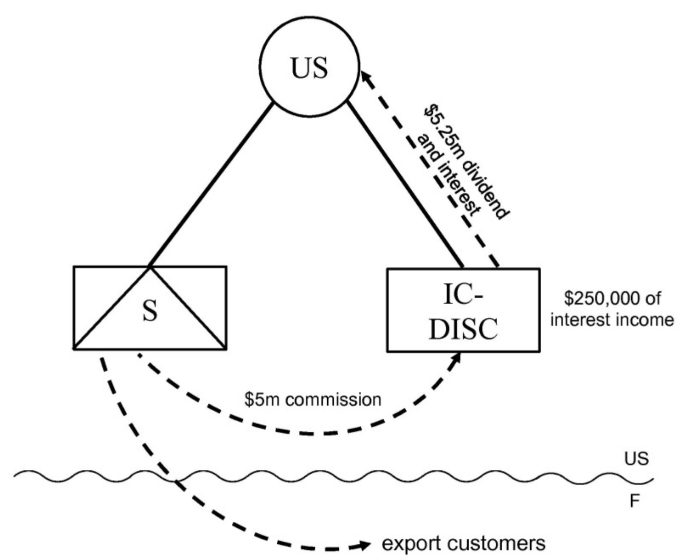


H. Can move some, but only 5% of the receipts constituting non-qualified export receipts to take advantage of tax savings.

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

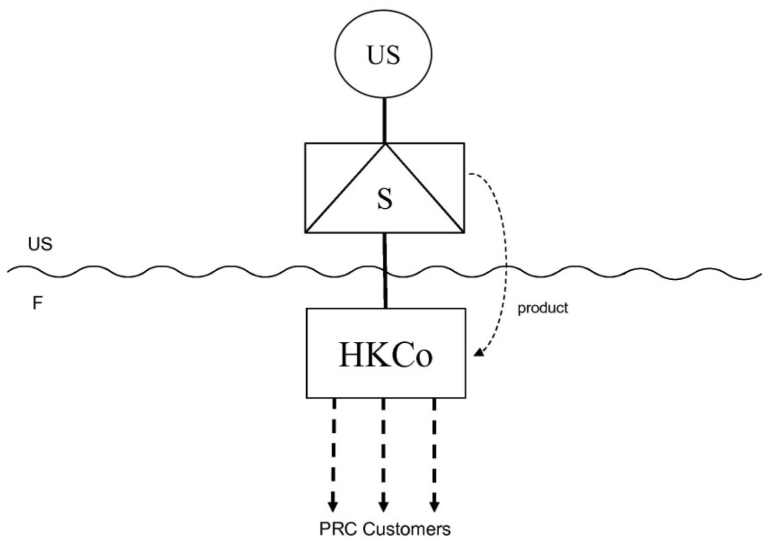


2. As long as $250,000 of interest income is less than 5% of all IC-DISC receipts, the interest income can be taxed at qualified dividend rates.

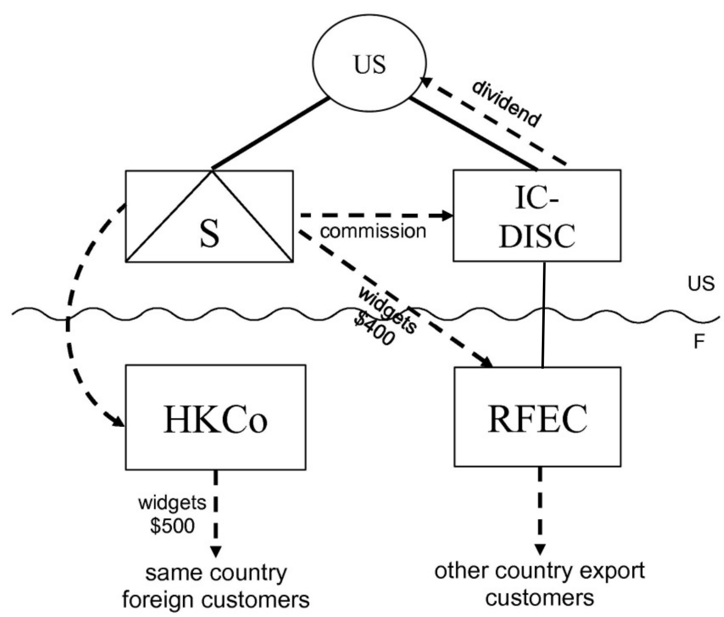


I. IC-DISC to avoid Subpart F.

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.

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[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.

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IC-DISCs: Structuring to Maximize Tax Benefits

Presented by

Robert Misey, Esq.

Chair, International Department
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rmisey@reinhartlaw.com

Partnering for your Success

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

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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

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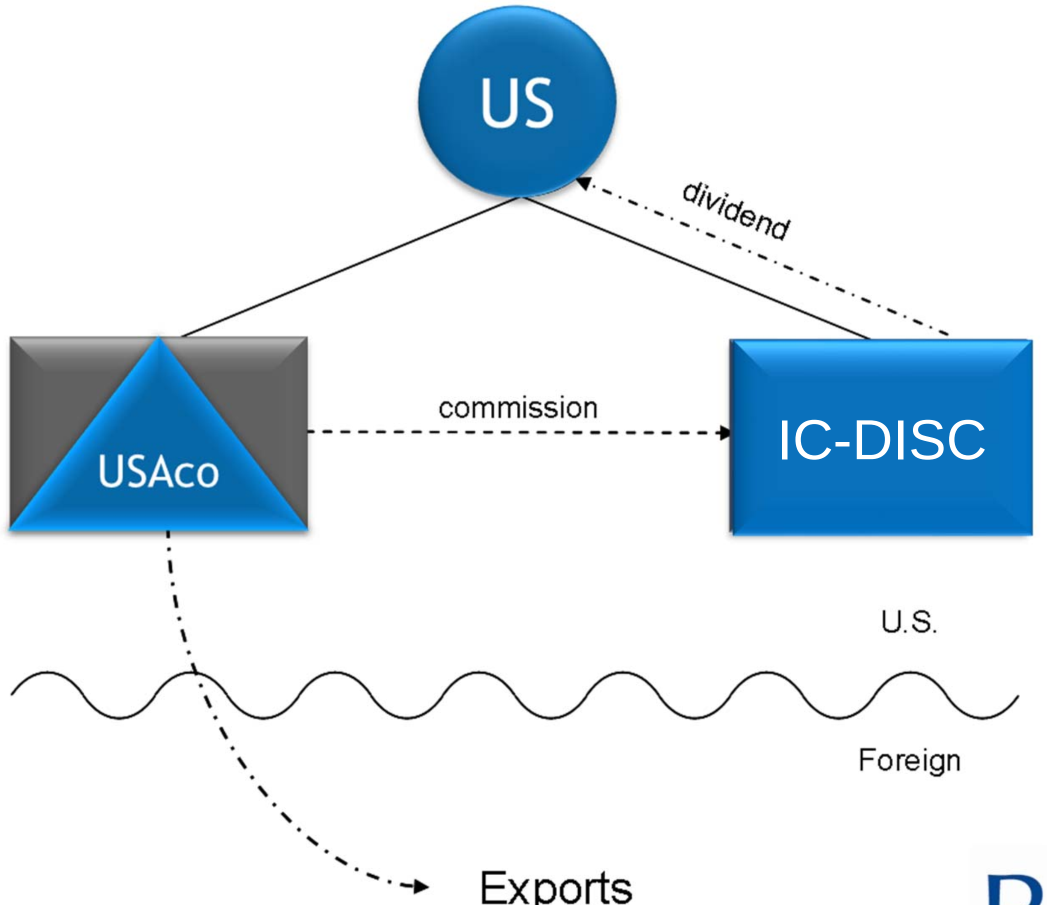
Example 1
Sales Produce Gross Receipts



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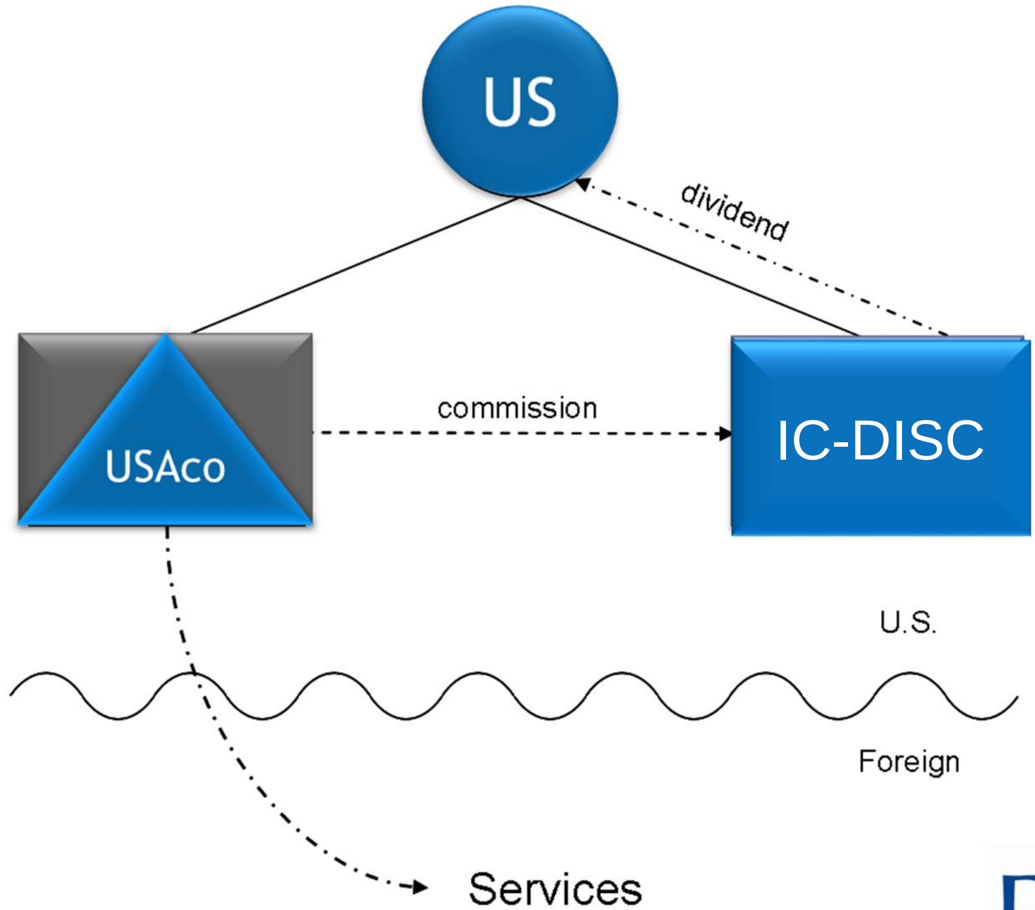
Example 2

Services Produce Gross Receipts



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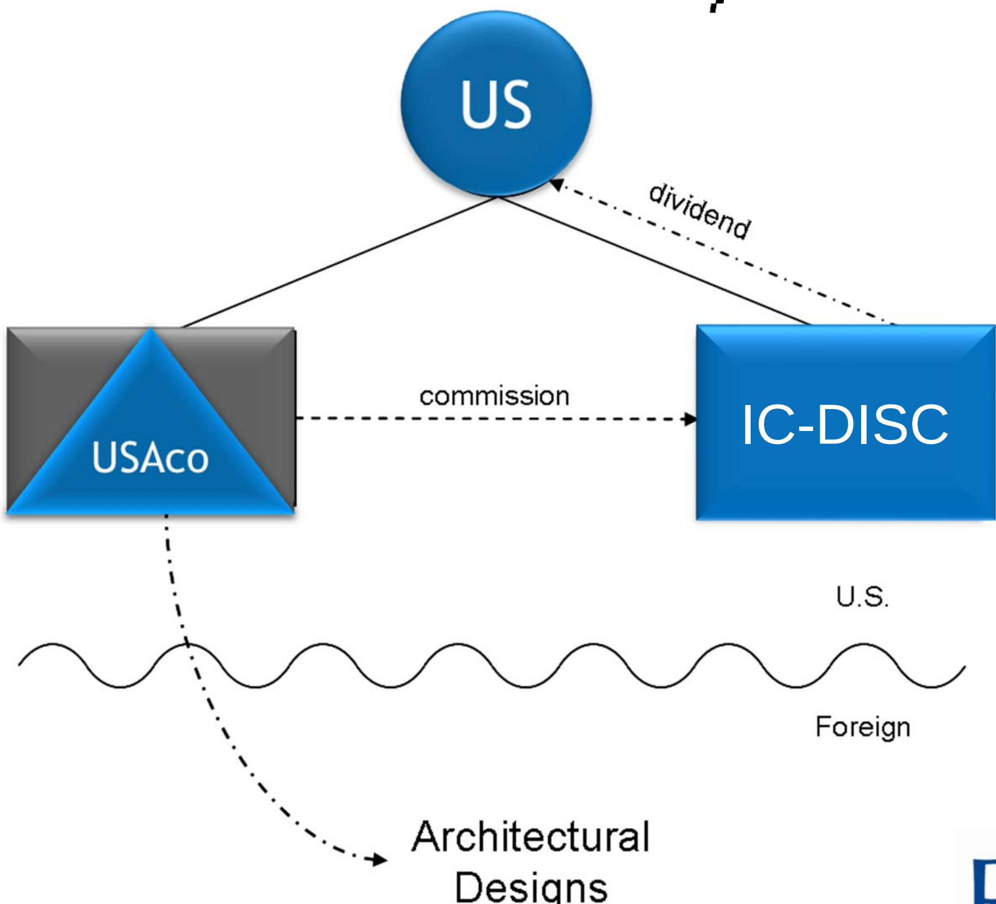
Example 3
Architectural Services Produce Gross Receipts



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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

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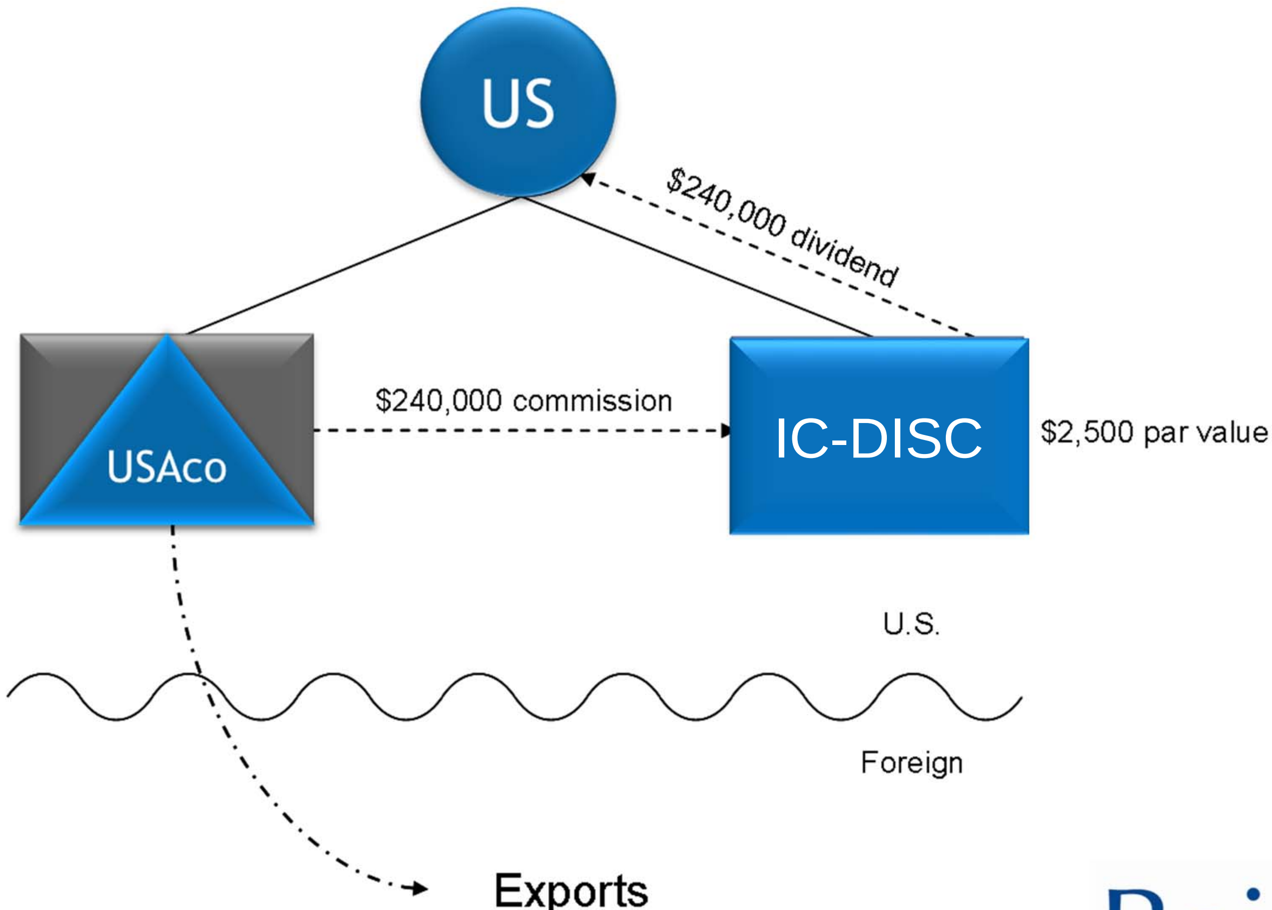
Example 4

Working Capital as Qualified Export Assets



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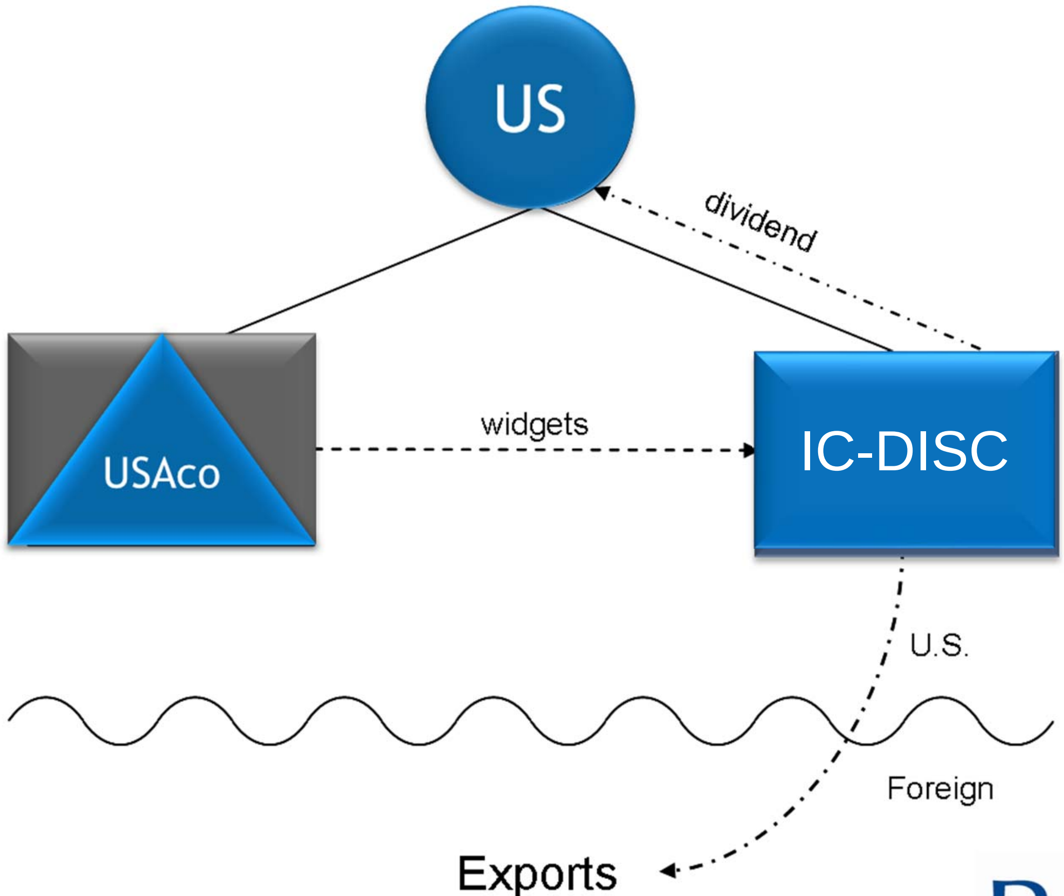
Example 5
Export Property as Qualified Export Assets



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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

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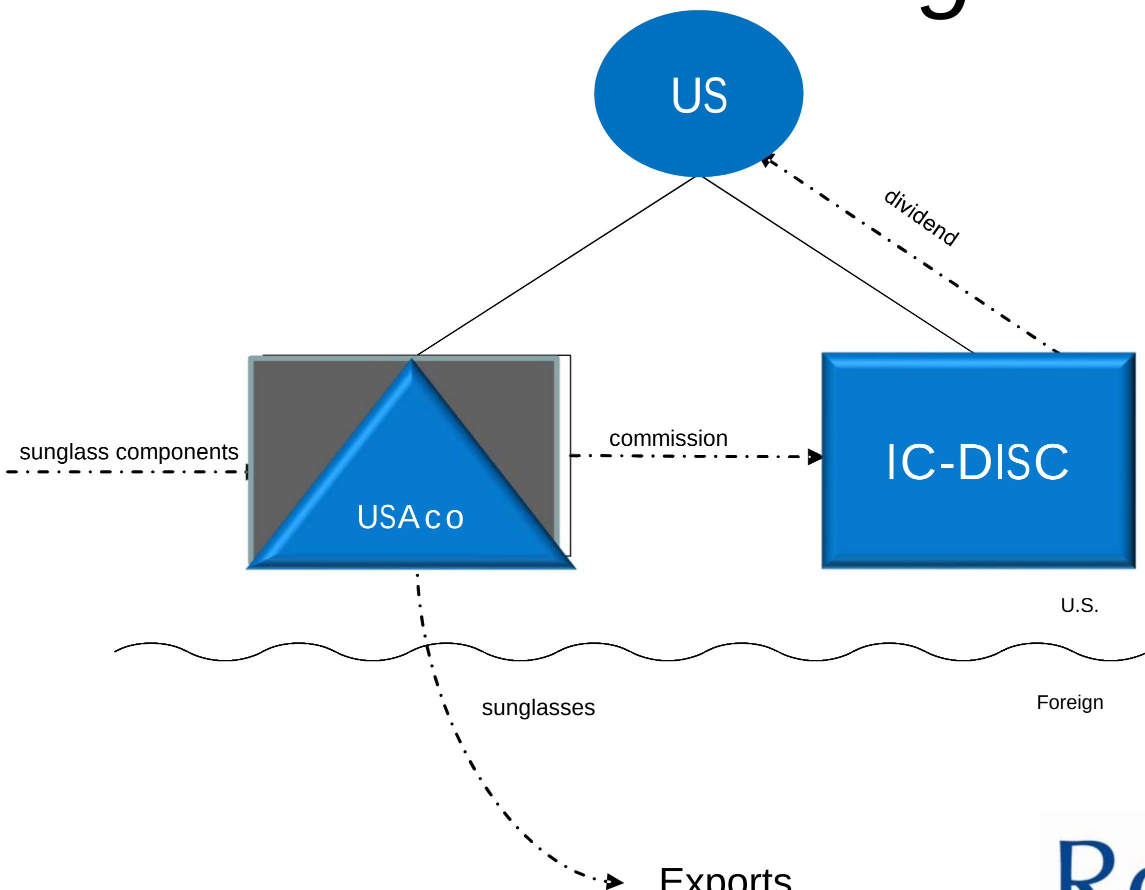
Qualification as Export Property (cont.)

- 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



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Qualification as Export Property

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

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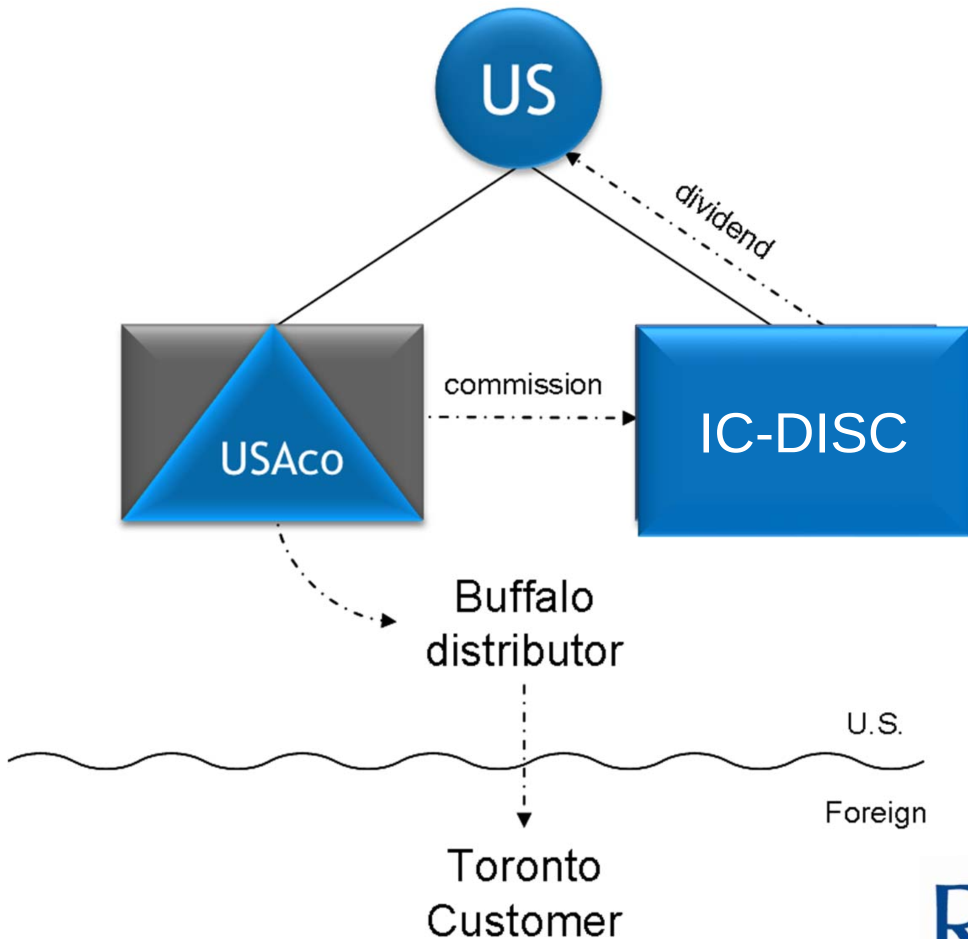
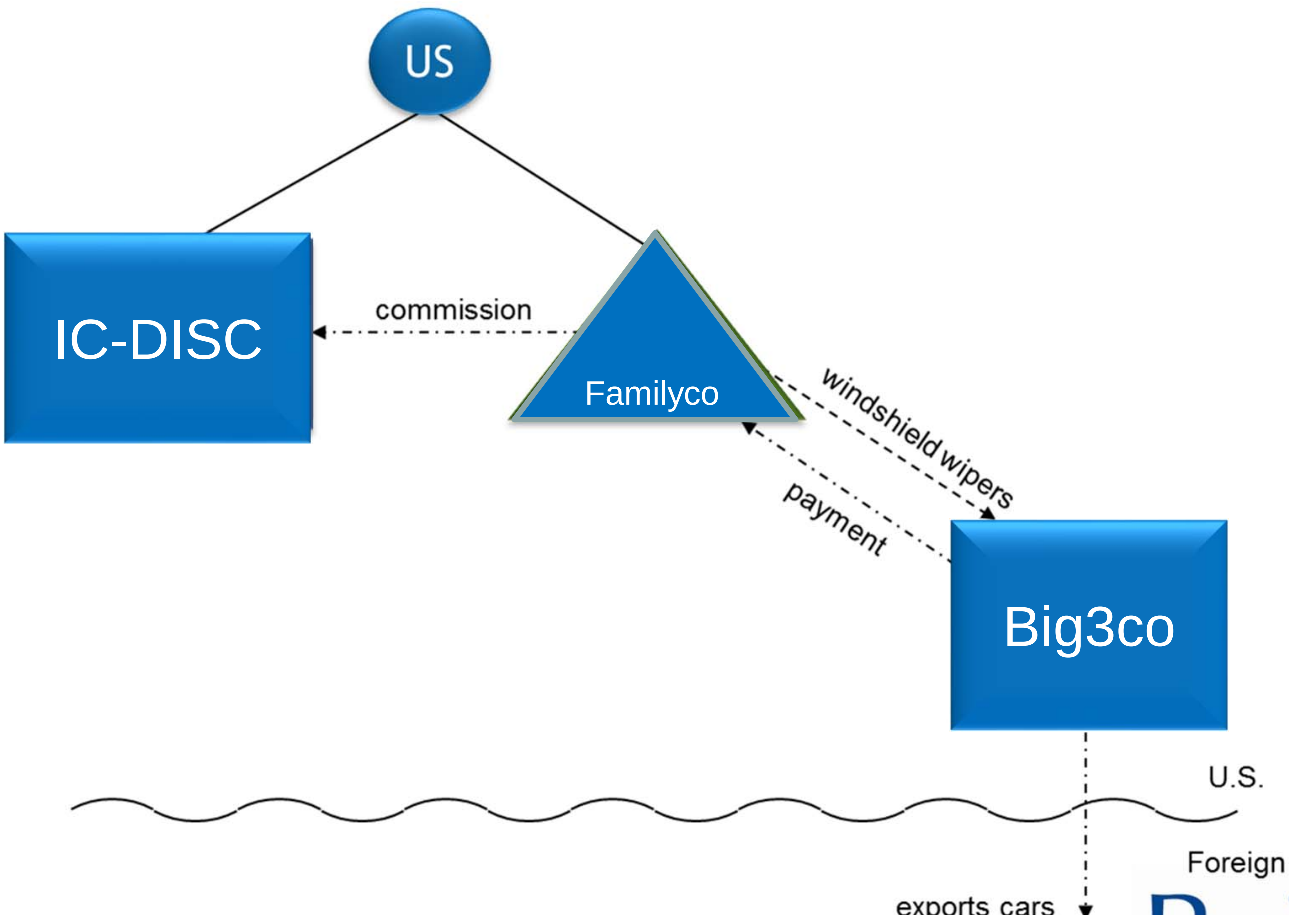
Example 7
Satisfying the Destination Test



Example 8

No Further U.S. Manufacturing



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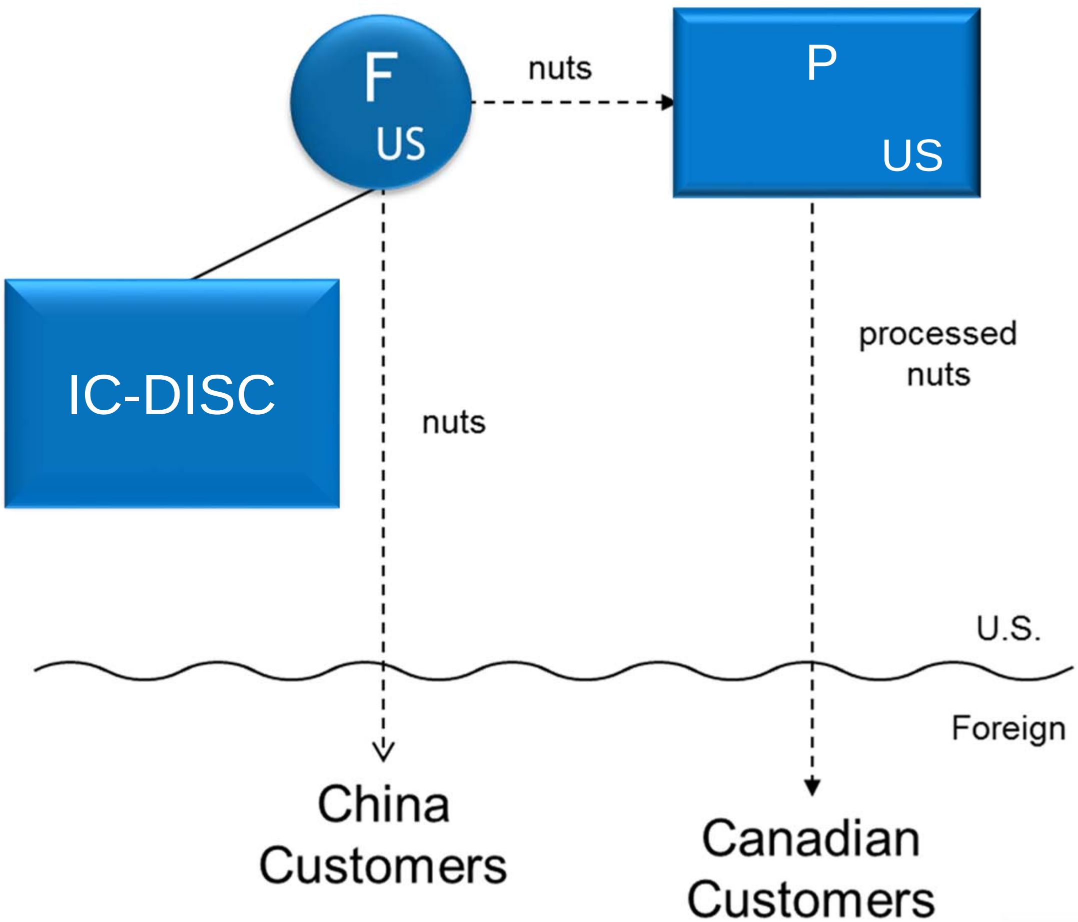
Example 9



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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

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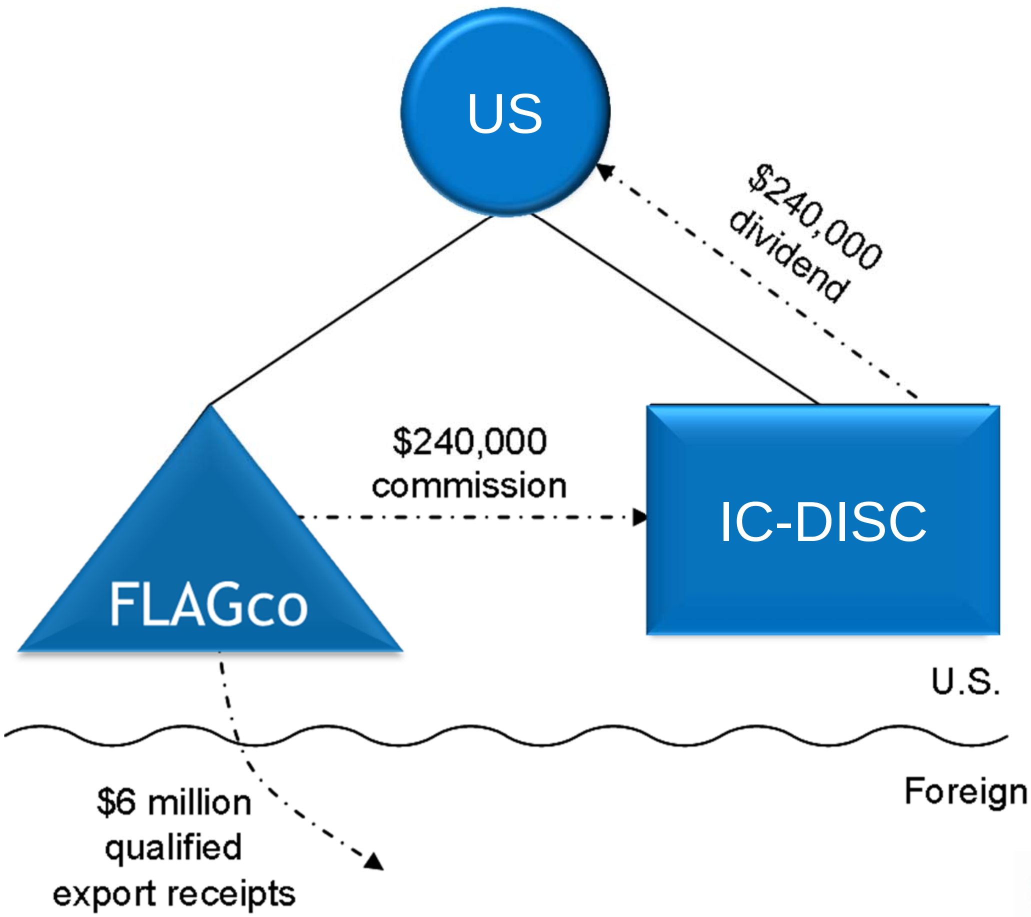
Determining the IC-DISC Benefit

- 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



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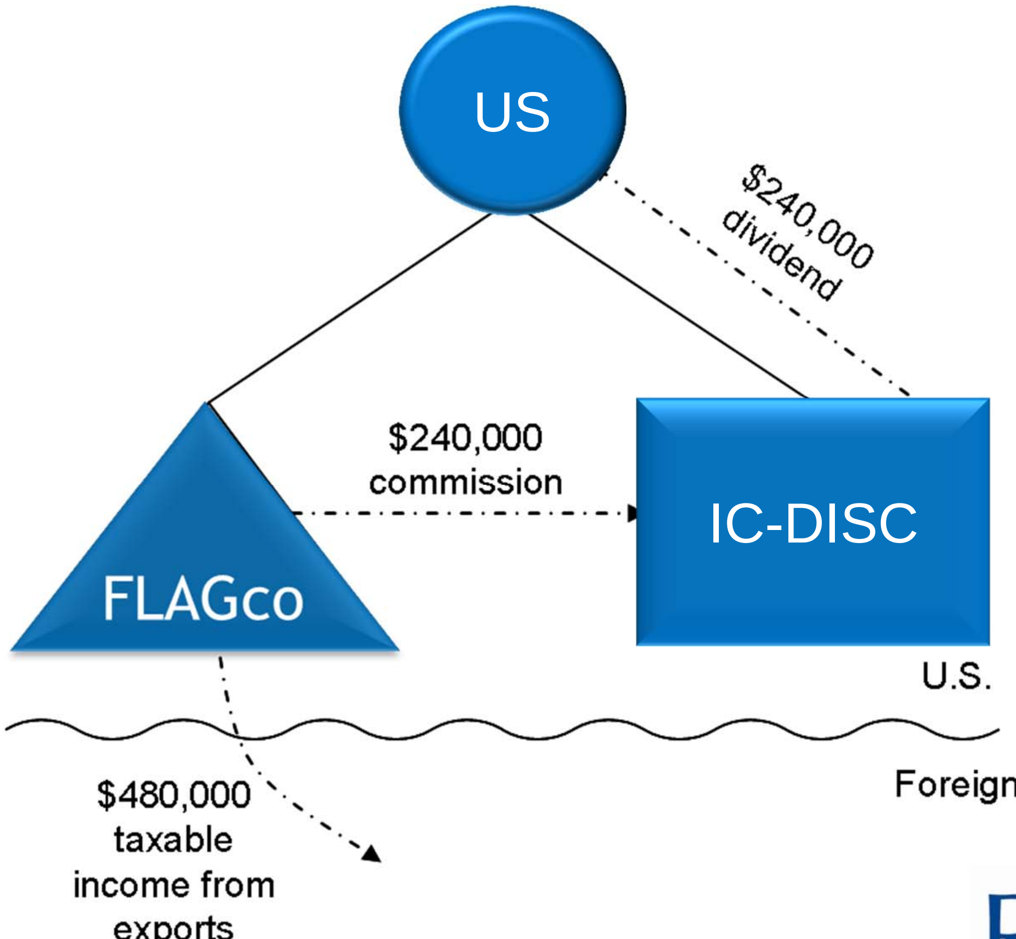
Example 11
50% of Combined Taxable Income



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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

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Example 12
Grouping to Maximize Commissions

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

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

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

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

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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

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

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

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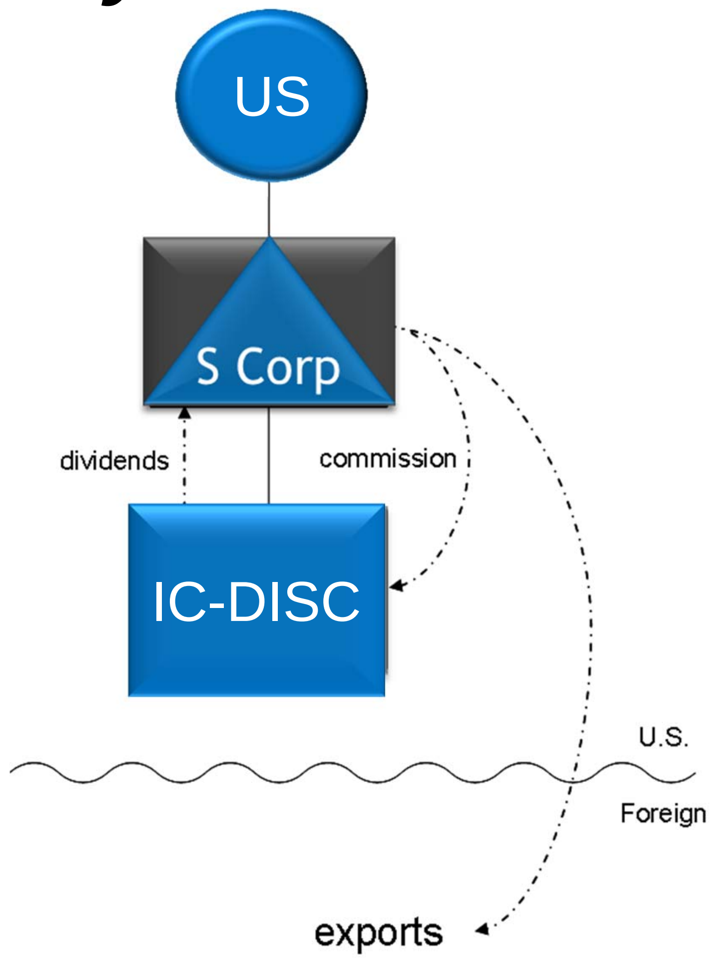
Structuring the IC-DISC
Subsidiary of a Flow-Through



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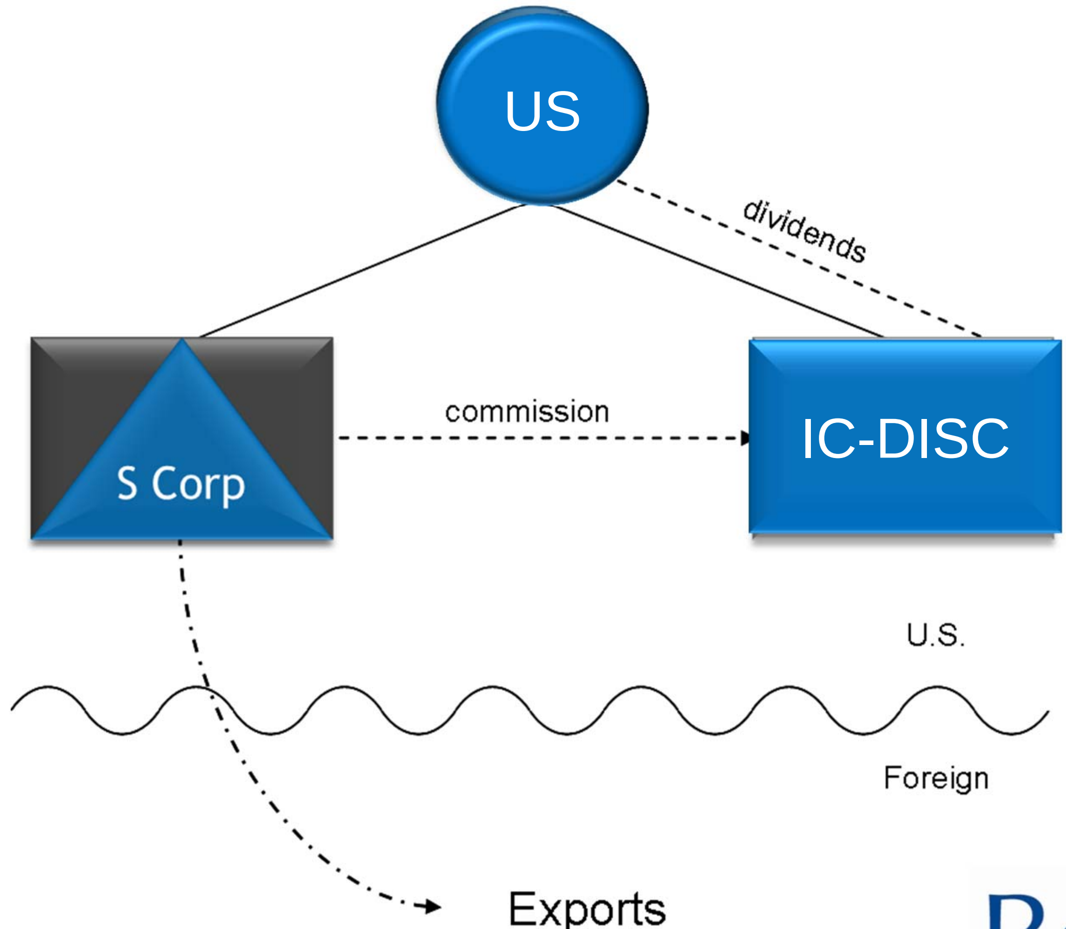
Structuring the IC-DISC
Brother-Sister of a Flow-Through



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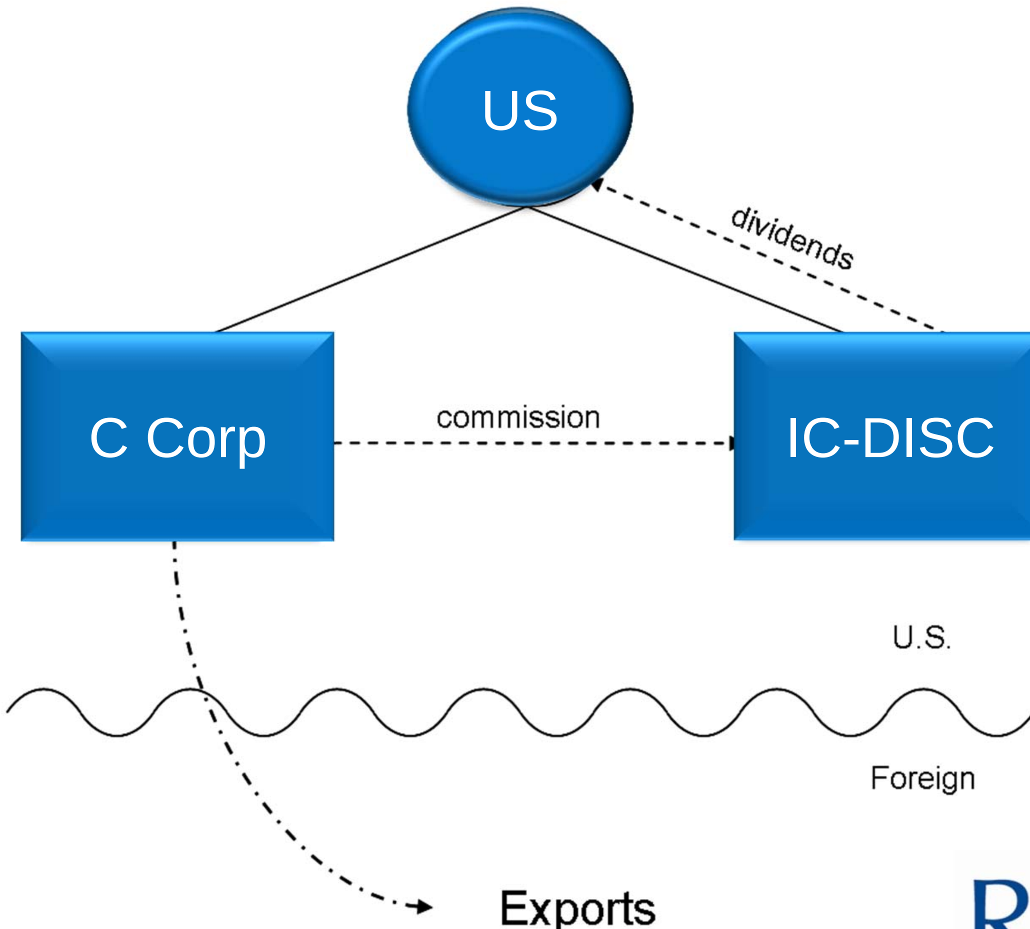
Structuring the IC-DISC
Brother-Sister of a C Corporation



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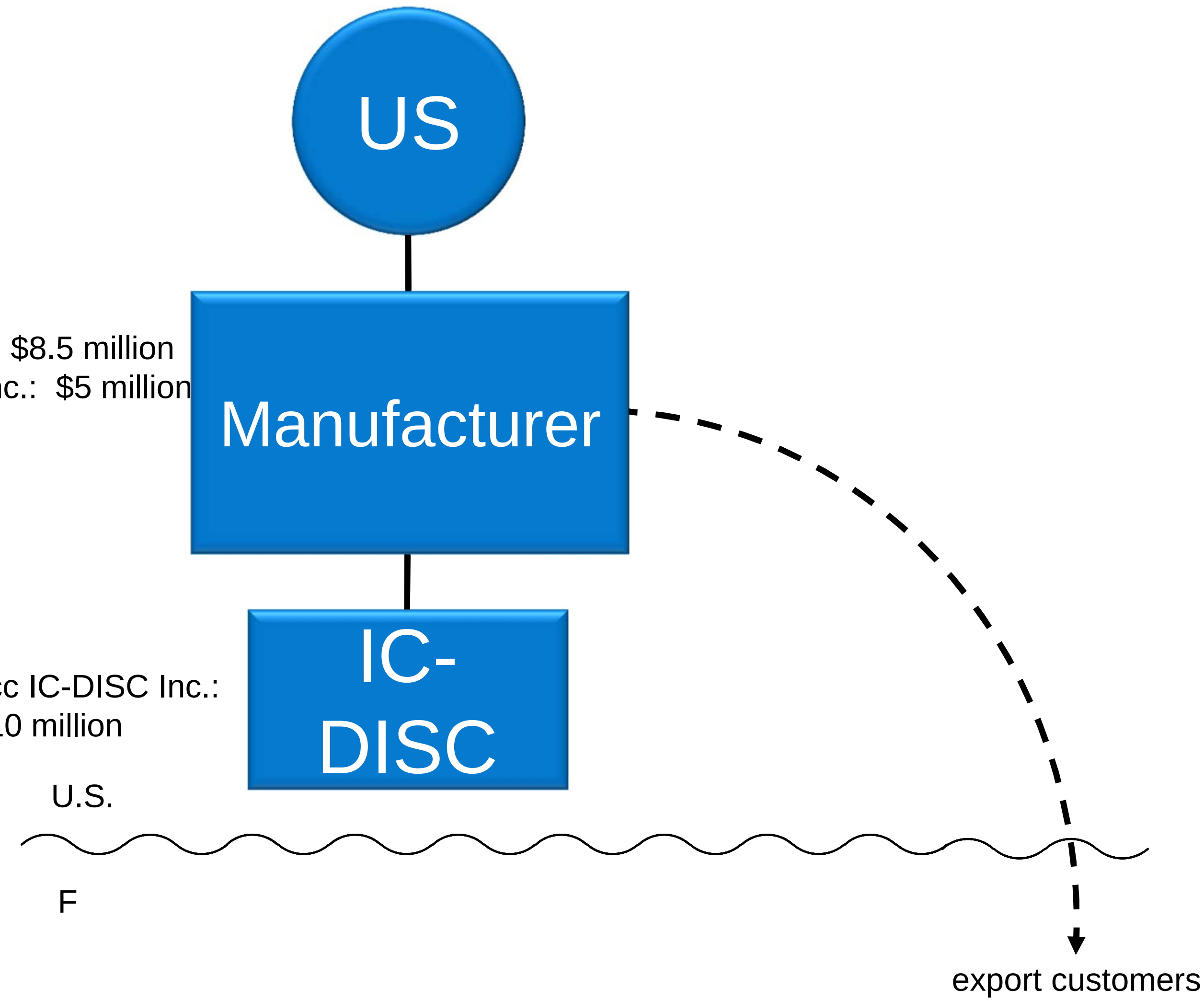
The Interest Charge in IC-DISC

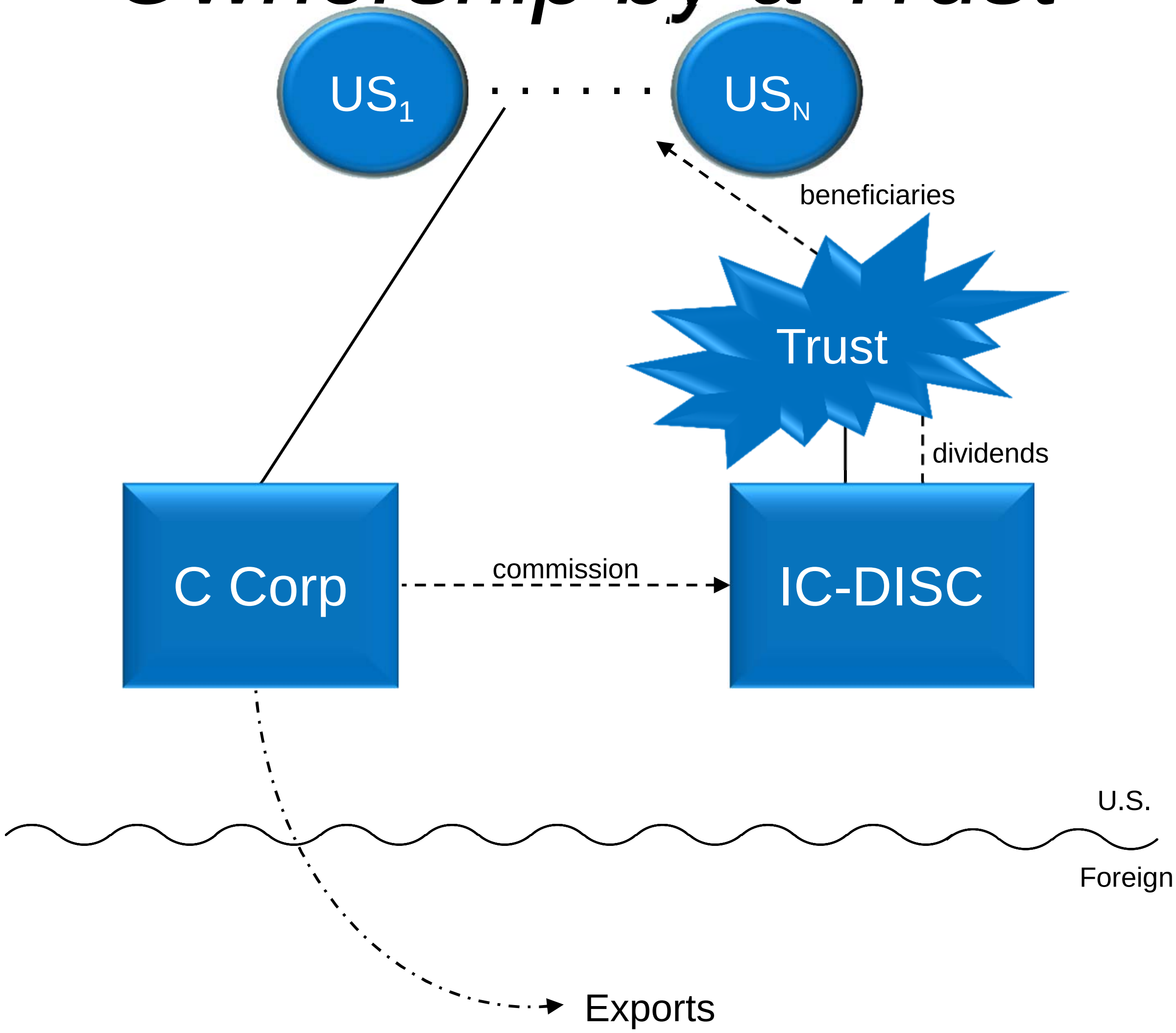
U.S. tax – with acc IC-DISC Inc.: $8.5 million
U.S. tax – without acc IC-DISC Inc.: $5 million
Deferred U.S. tax: $3.5 million
AFR: 1%
Interest: $350,000

acc IC-DISC Inc.:
$10 million

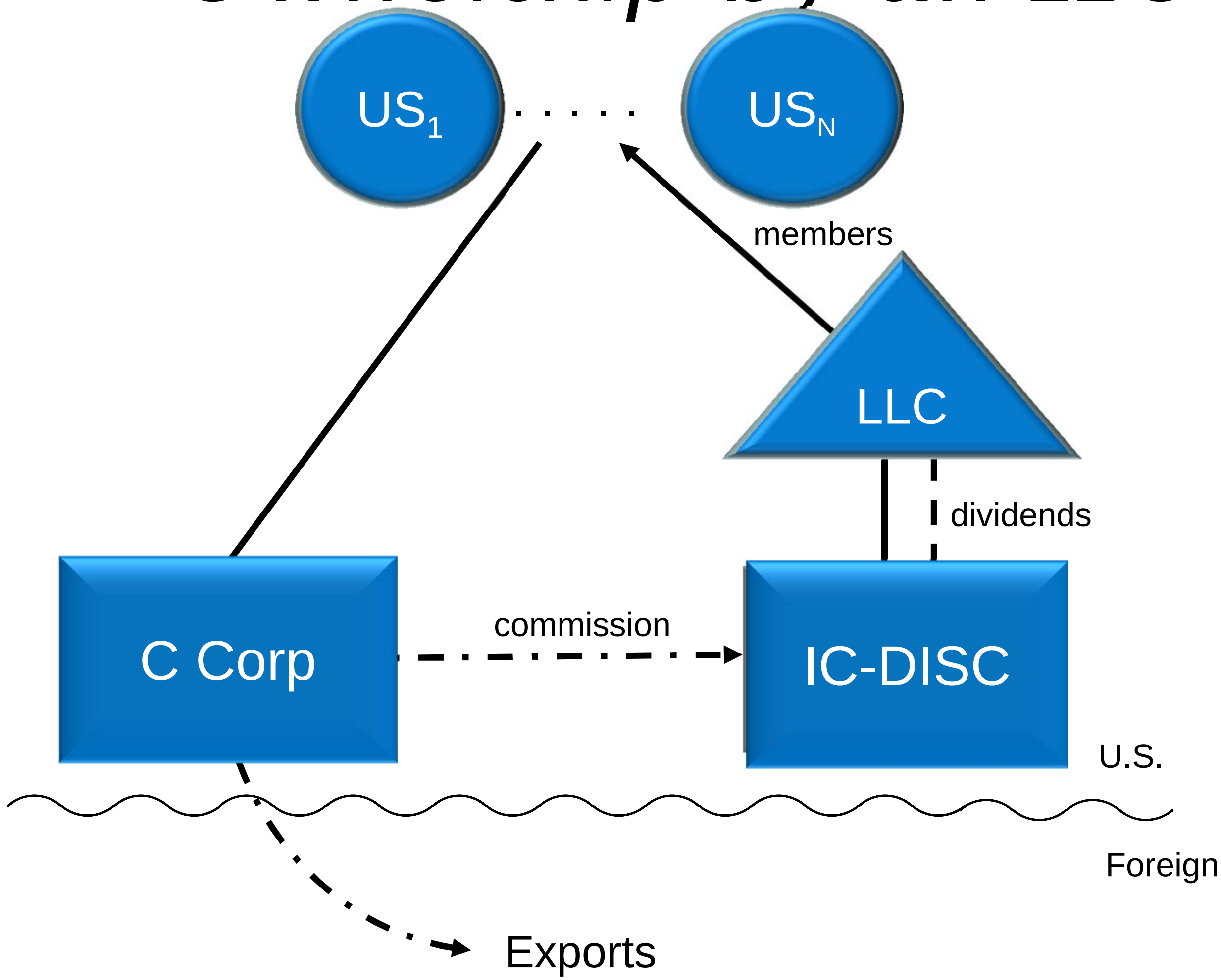


Structuring the IC-DISC

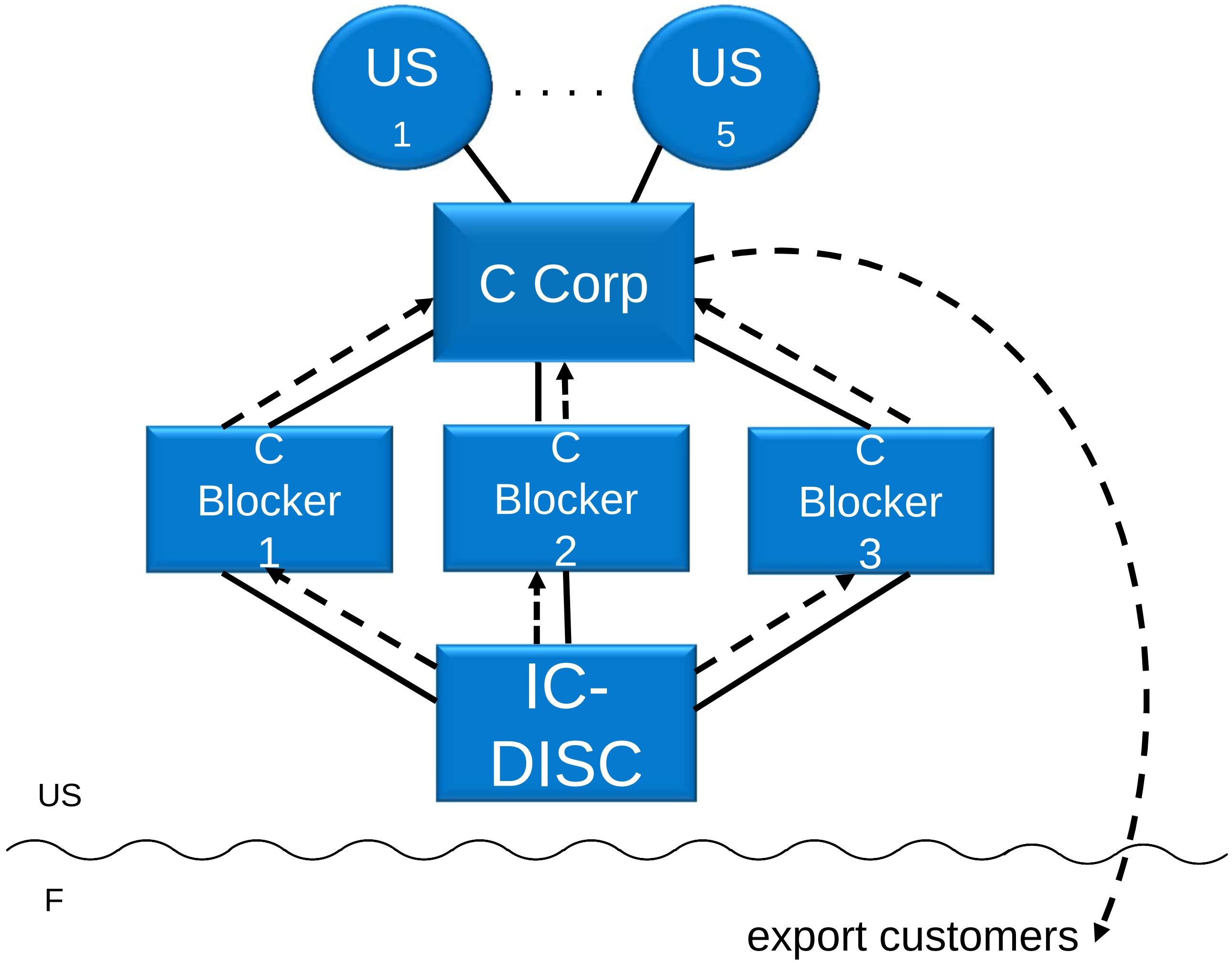
Ownership by a Trust



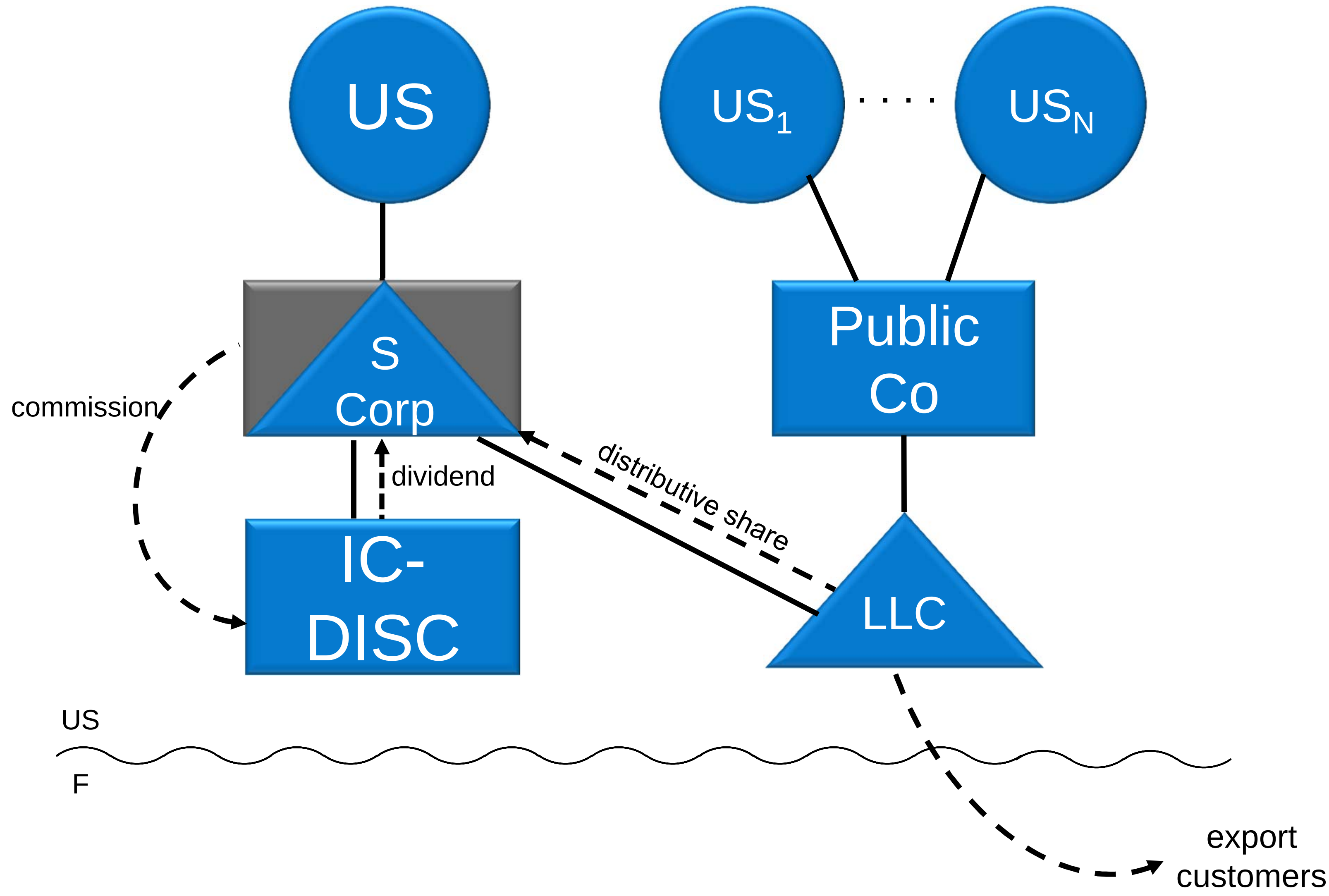
Structuring the IC-DISC
Ownership by an LLC



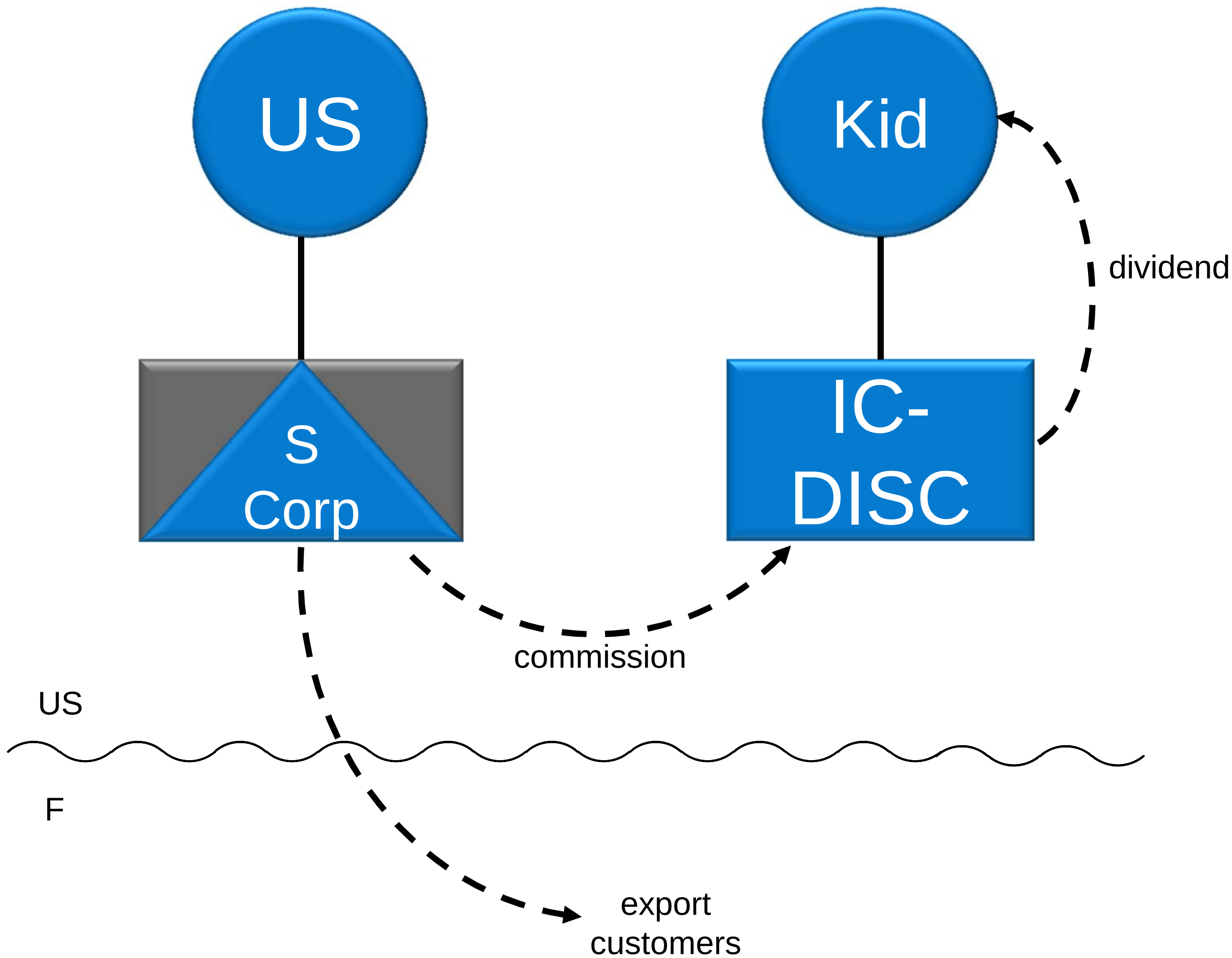
Multiple C Corporations



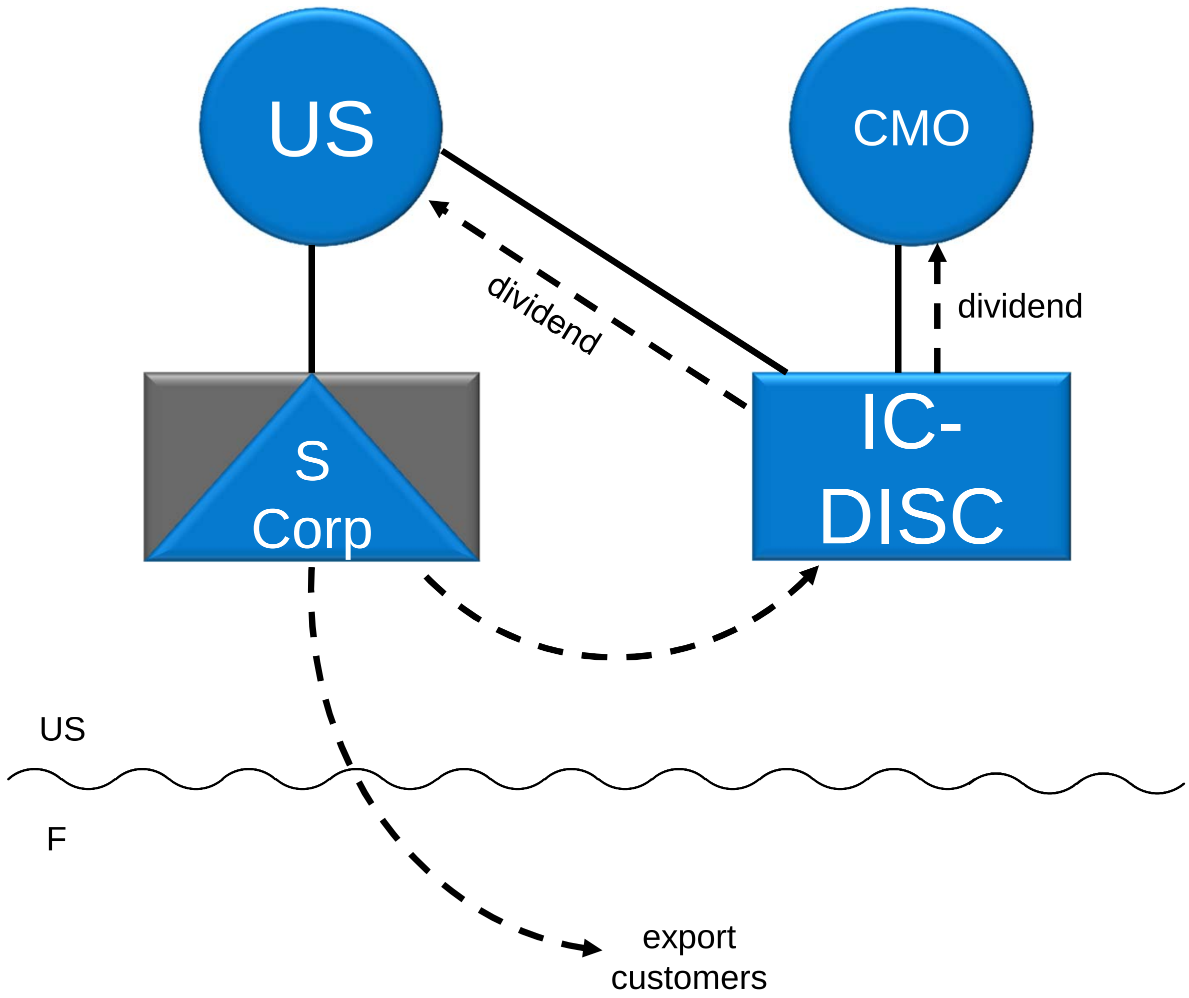
Joint Venture: S Corp and Public Co



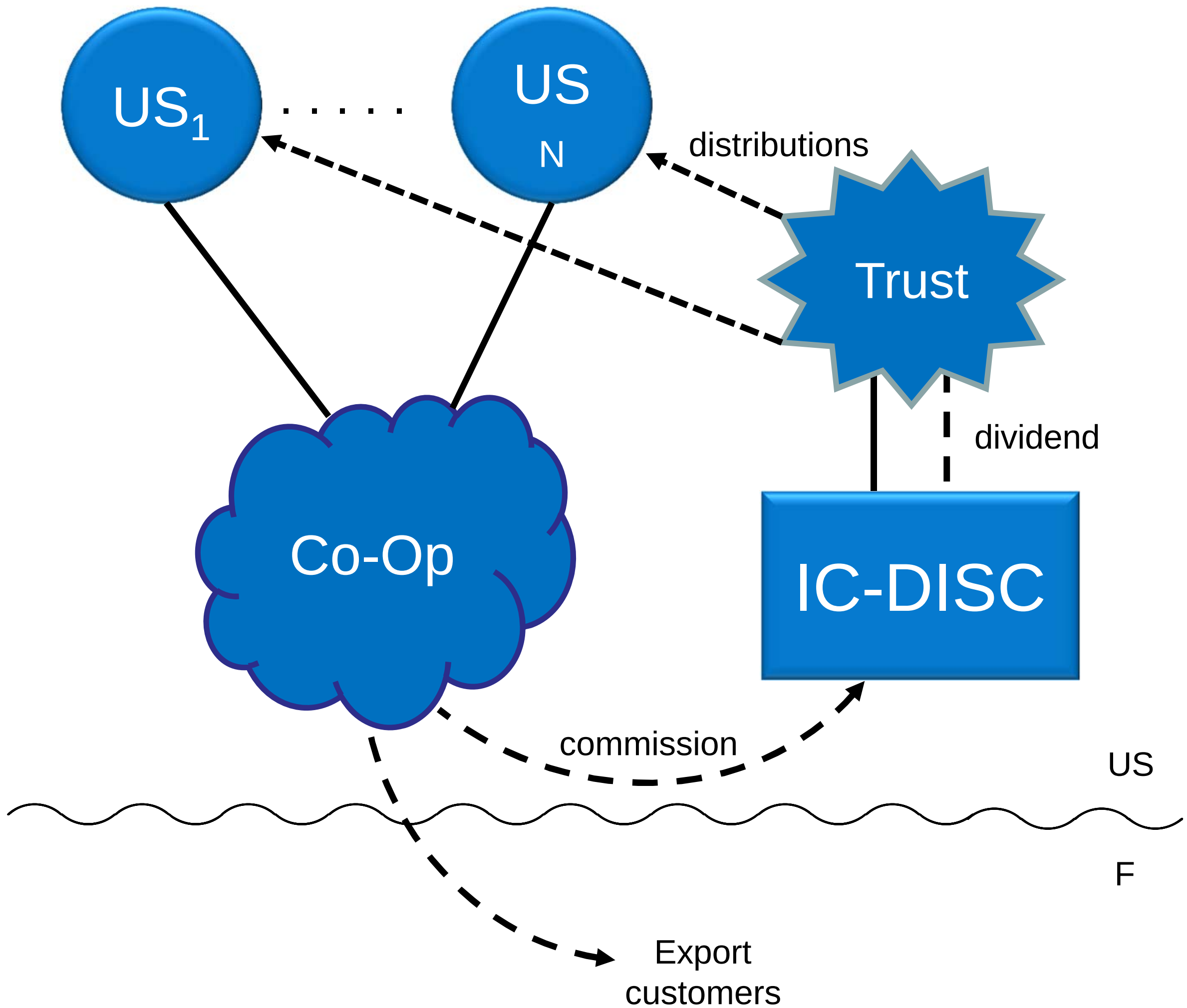
Gift Tax Implications?



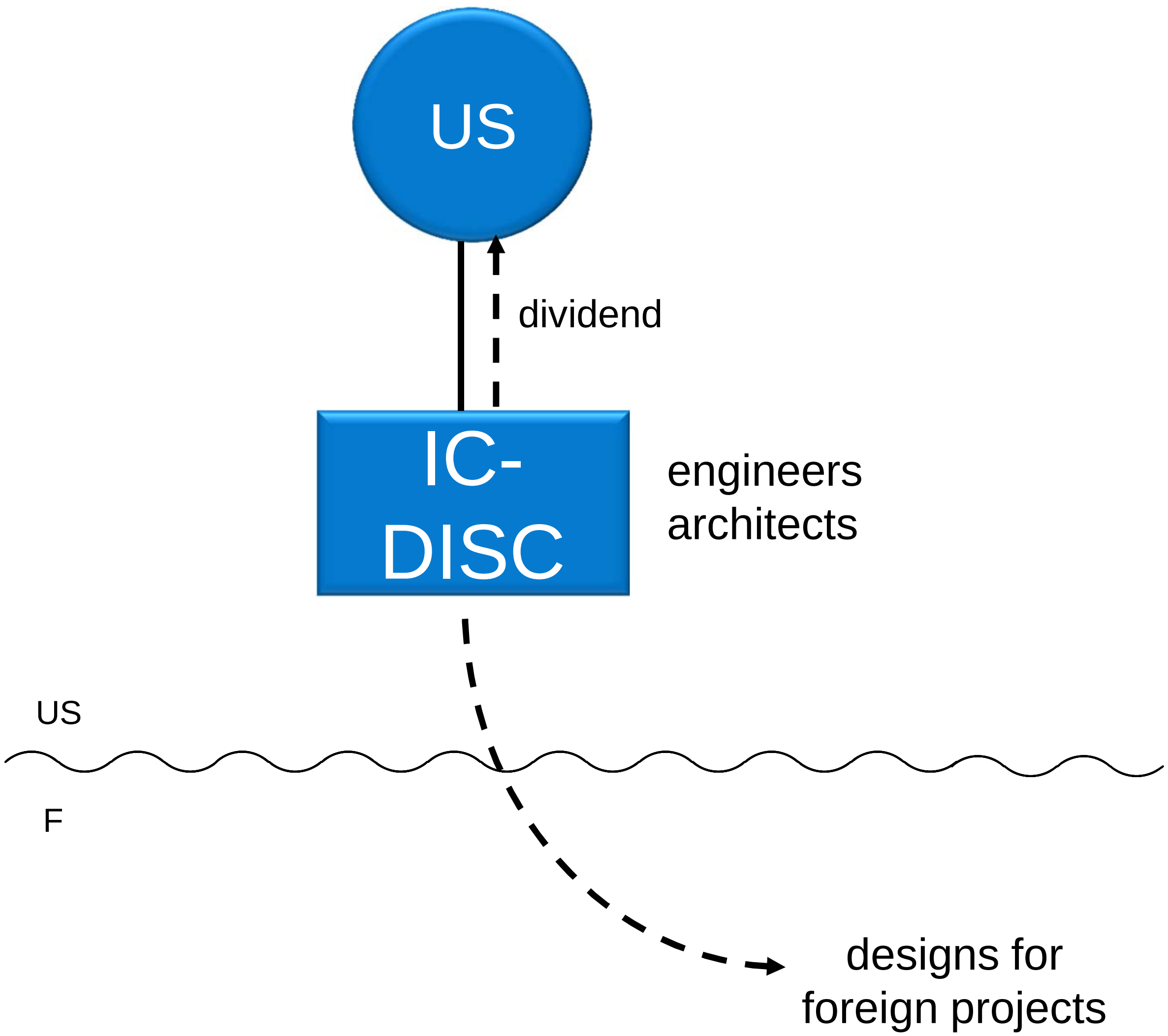
Non-Family Members



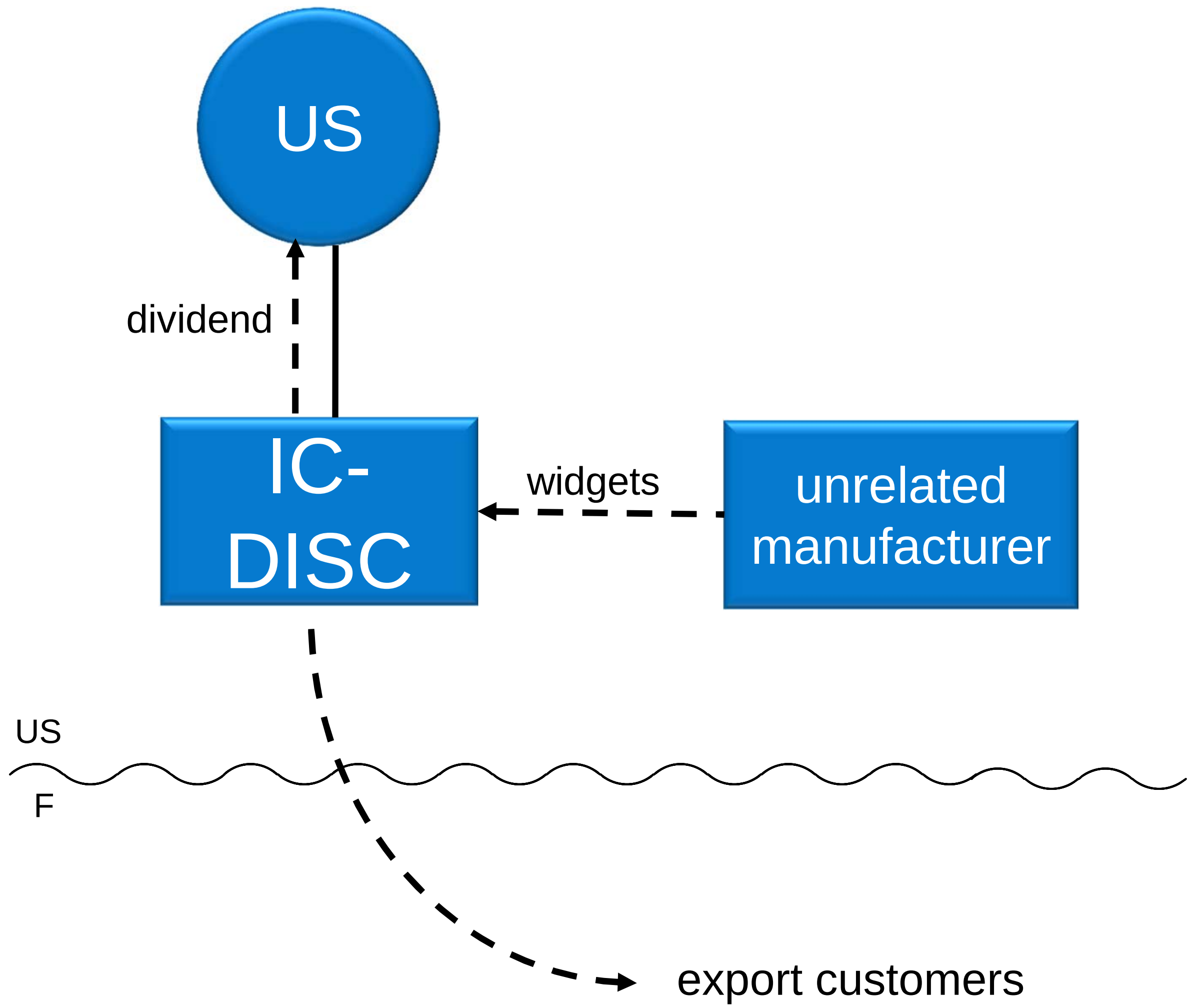
Trust For a Co-Op's Members



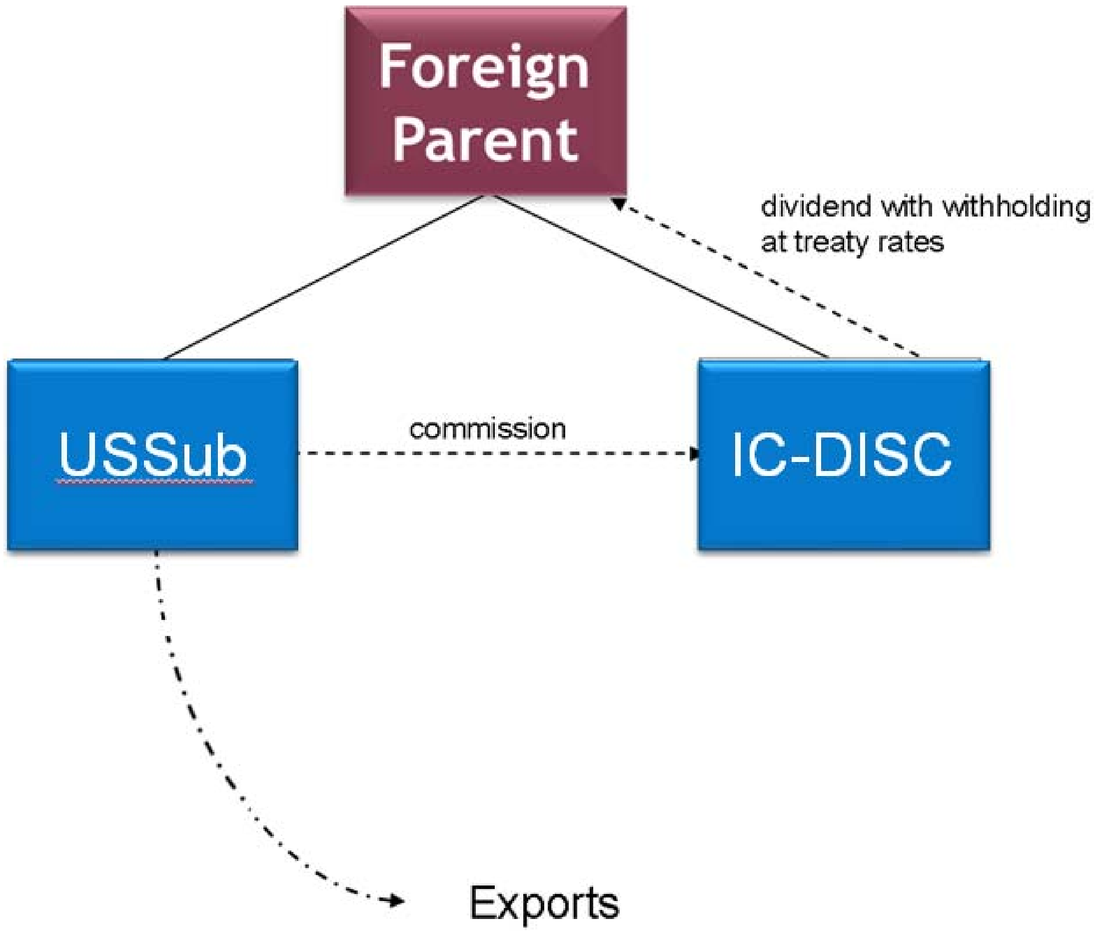
Architects and Engineers



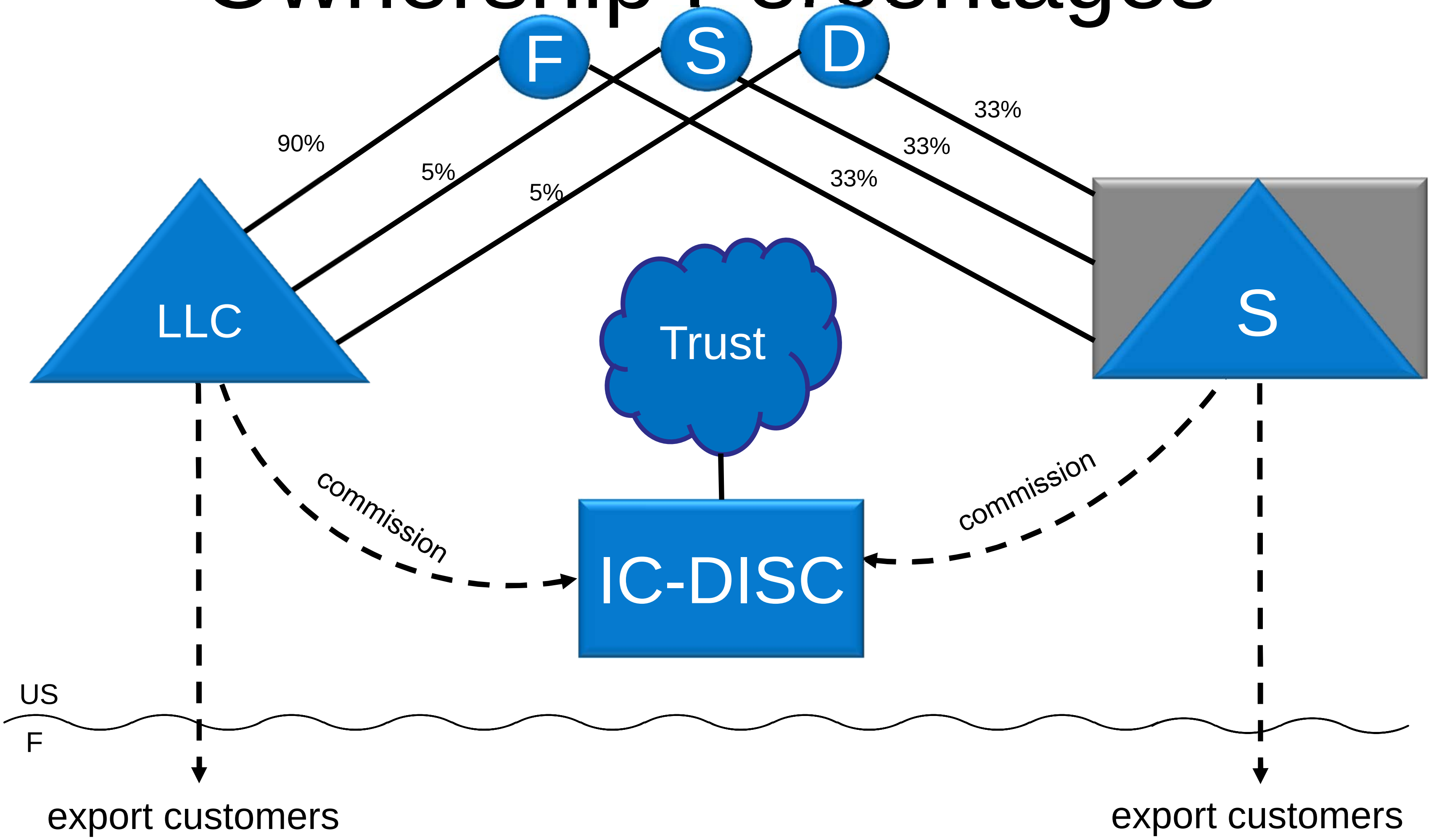
Pure Distributor



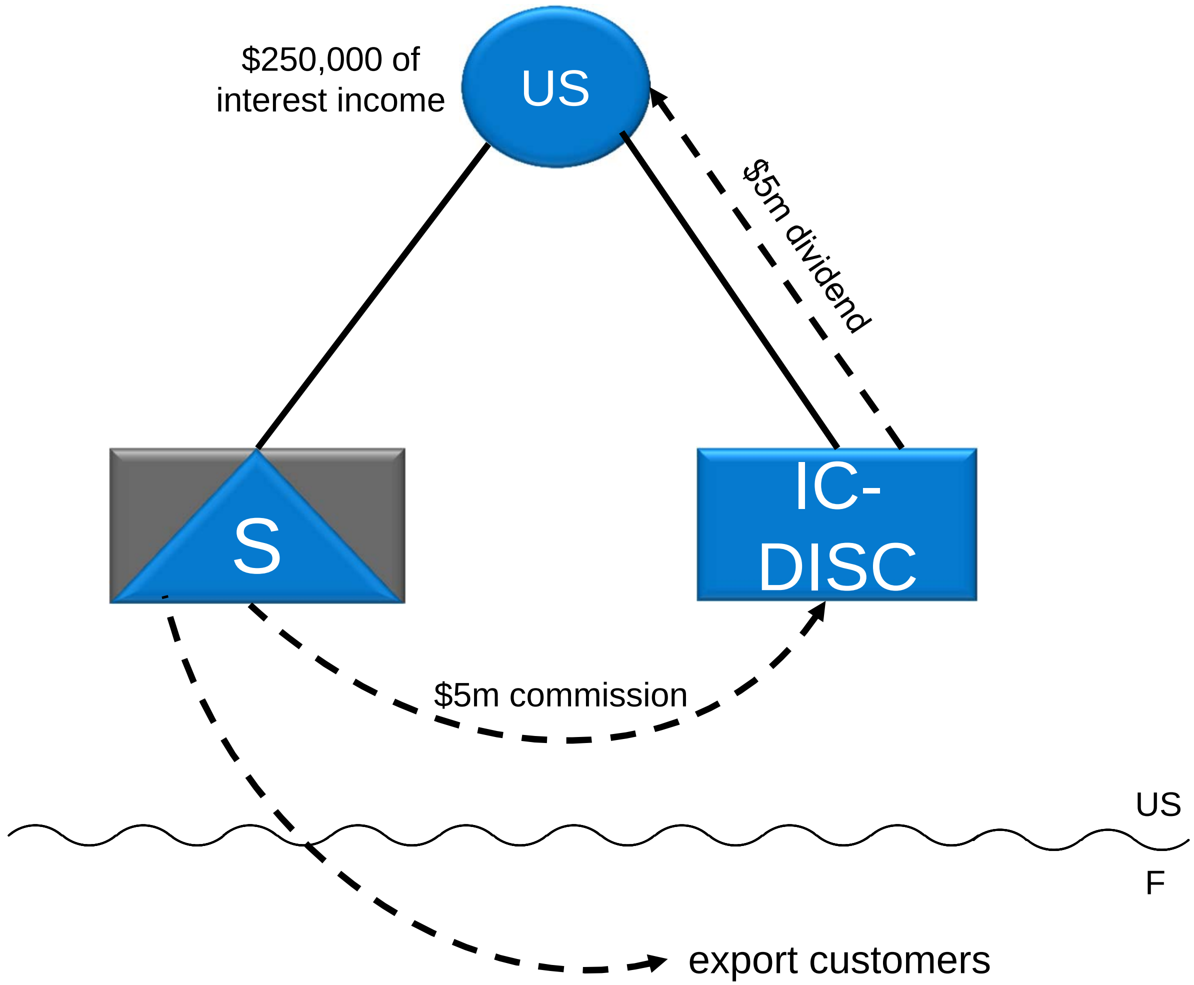
Inbound Treaty Benefits



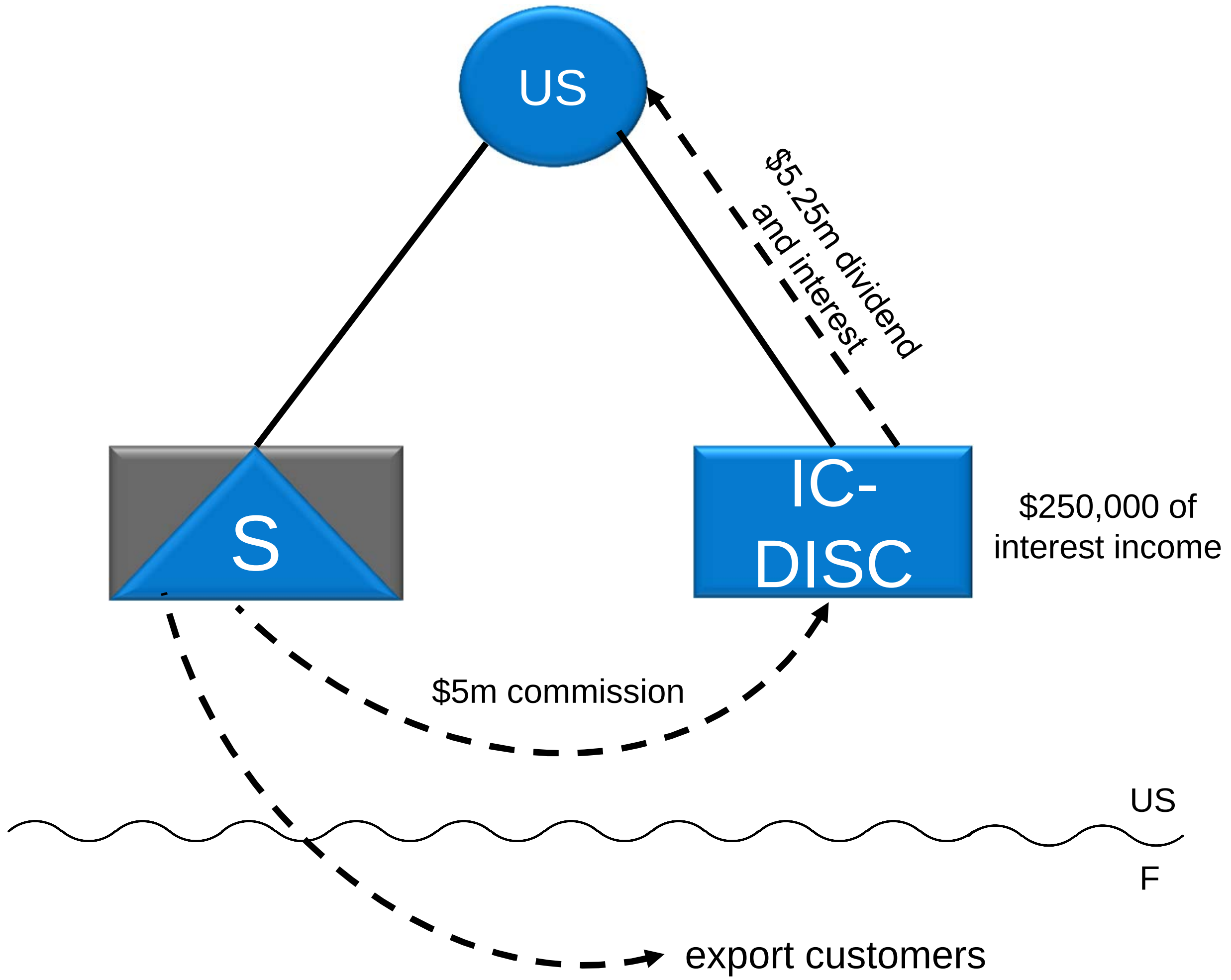
Use of a Trust With Varying Ownership Percentages



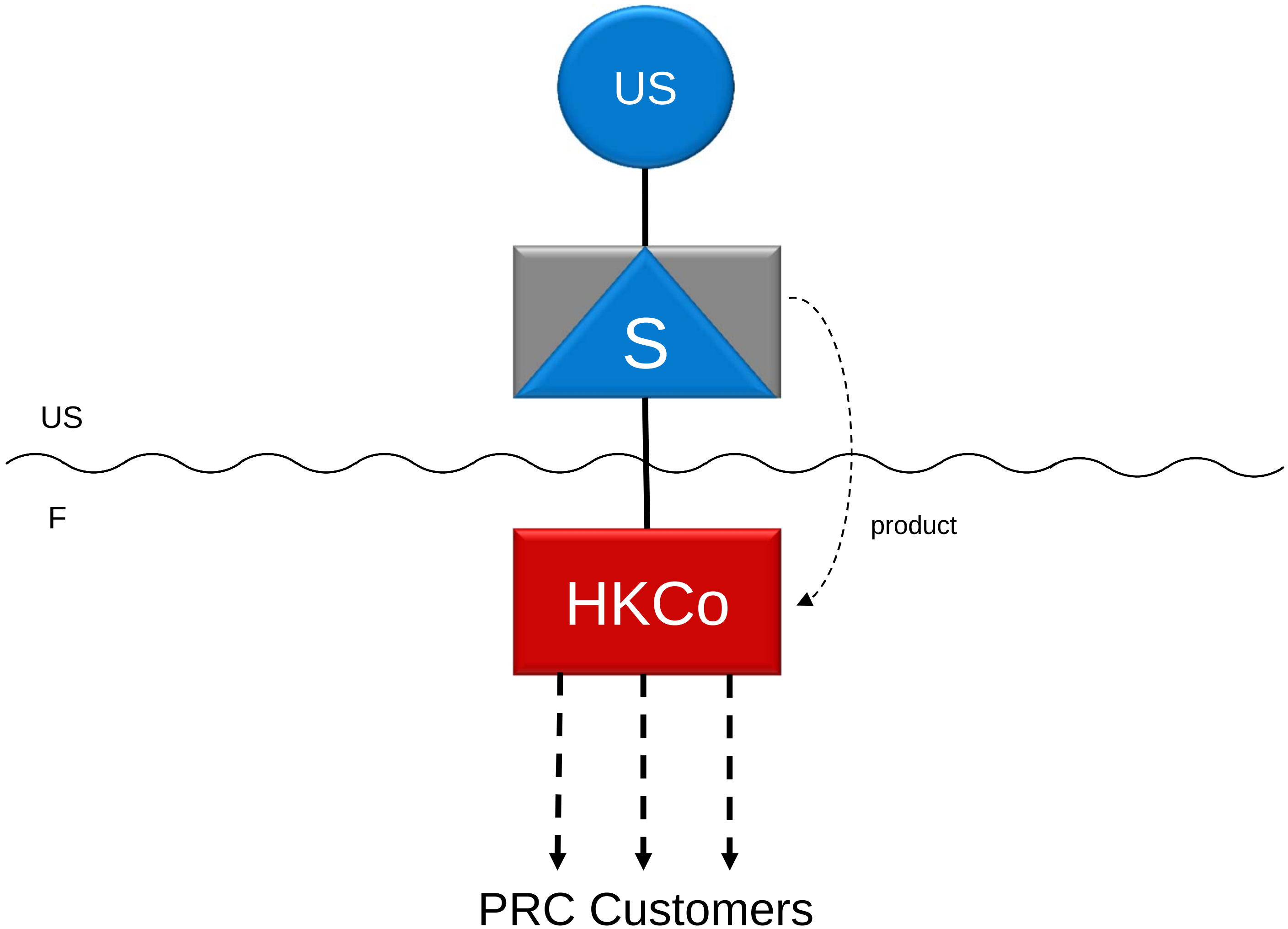
Non-Qualified if Tests Ignored



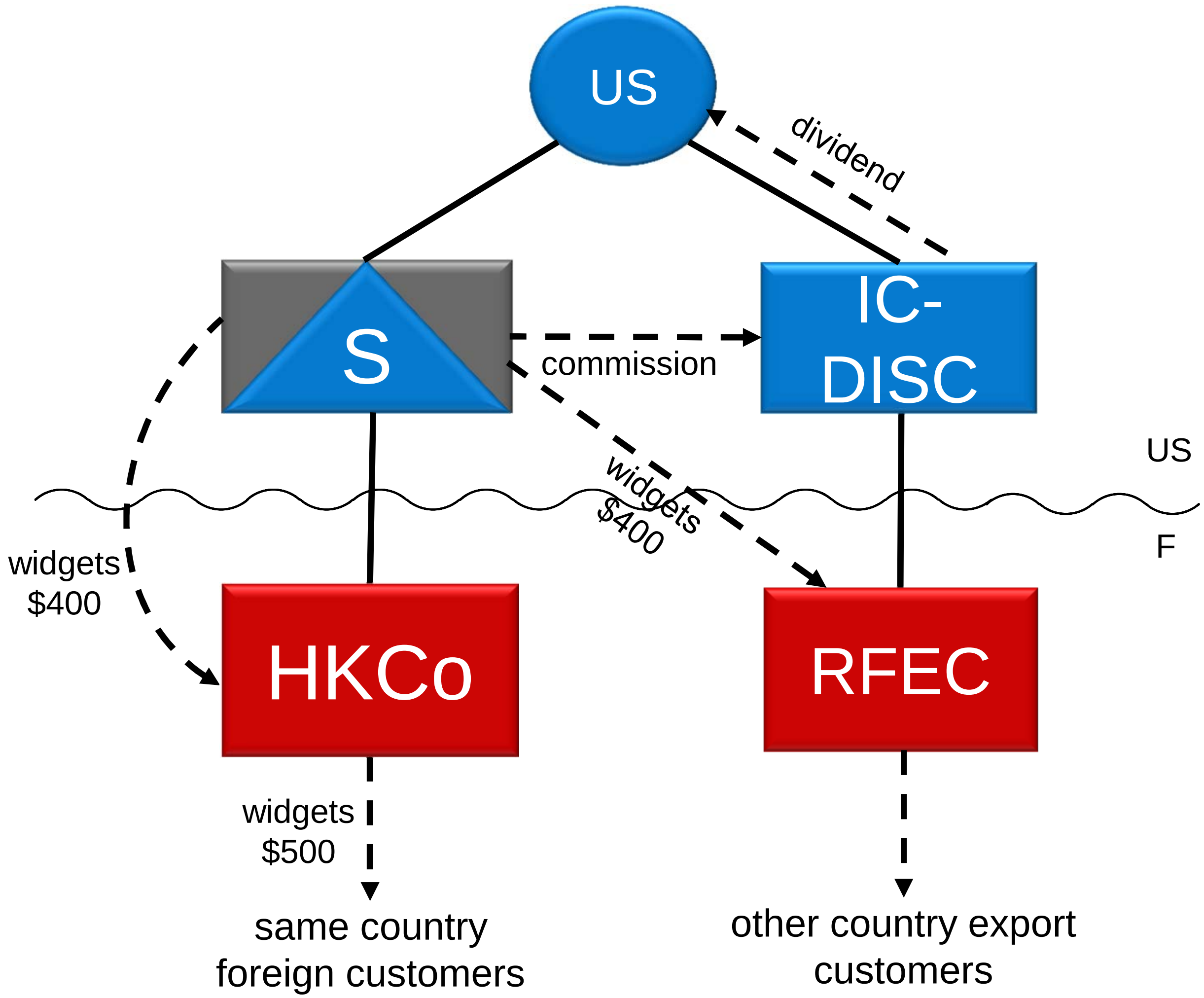
…but Benefits if Tests Satisfied



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

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About Rob Misey

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Chief Counsel

IRS

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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Austin, Texas
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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

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- International Taxpayers
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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 (MOP % x $ 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

e 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 changed 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 taxpayers 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. — **Yes** | **No**

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 . . . . . .

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	1,600,000	2,050,000	1,000,000	1,700,000	**2,100,000**	2,250,000

HAB Year: 2013
MOP Penalty: $112,500 ($2,250,000 x 5%)

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

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. Back 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	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:

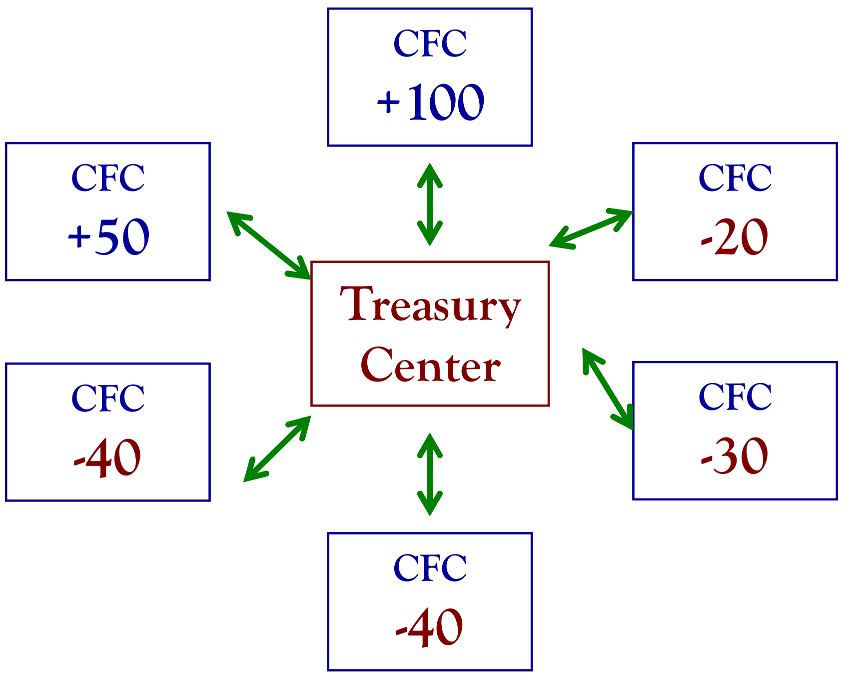
   Documentation
   a. Binding obligation to repay;
   b. Holder has creditor's rights to enforce the obligation

   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**.

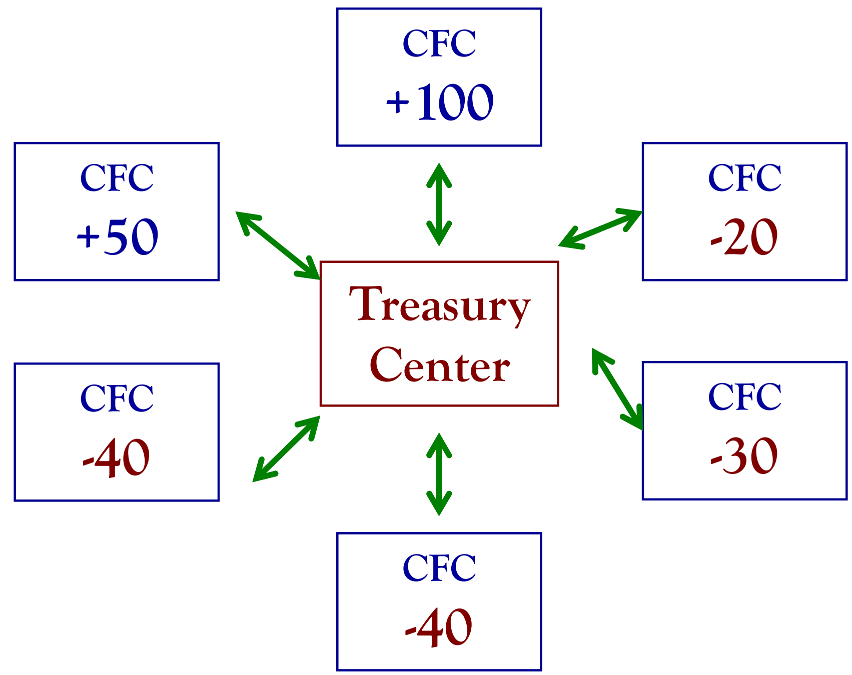
   Exceptions (Reg. 1.385-2(b)): (i) **Rebuttable Presumption** for "highly compliant" taxpayers, (ii) **reasonable cause exception**, and (iii) exception for **ministerial omissions**. These are very complicated exceptions.
4. **Effective date:** Effective for instruments issued after December 31, 2017.

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 threshhold 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

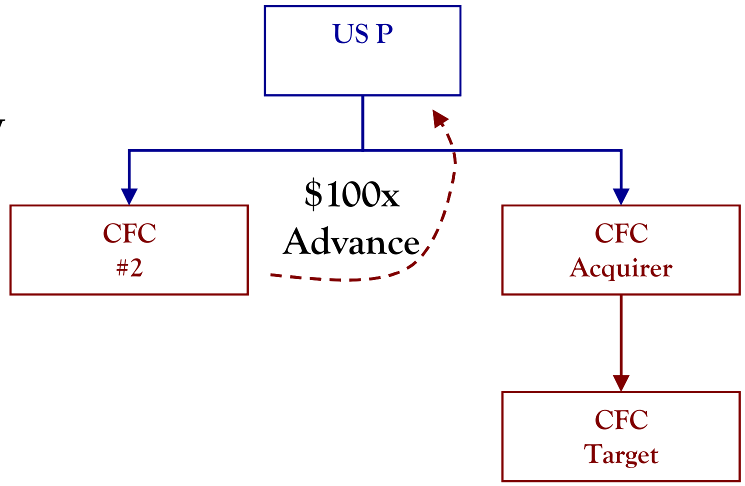
Hypo: A disregarded entity is owned by a corporate member of an Expanded Group. The DRE fails the documentation requirement so that the instrument issued by the DRE is treated as stock.

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

<u>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?</u>



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.

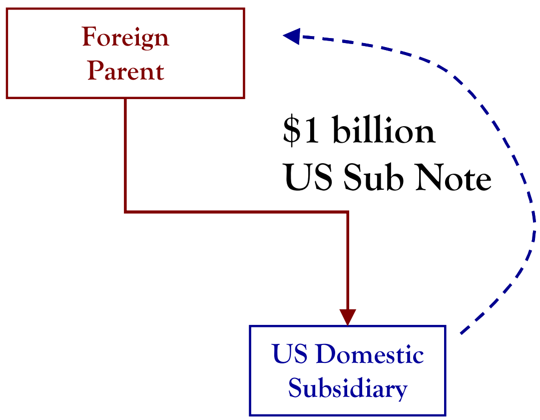
Exceptions:

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).

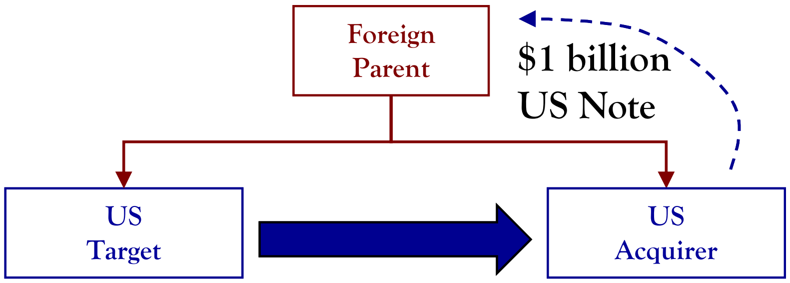
Per Se Rule
Recast Results

§301 Distribution of Instrument*



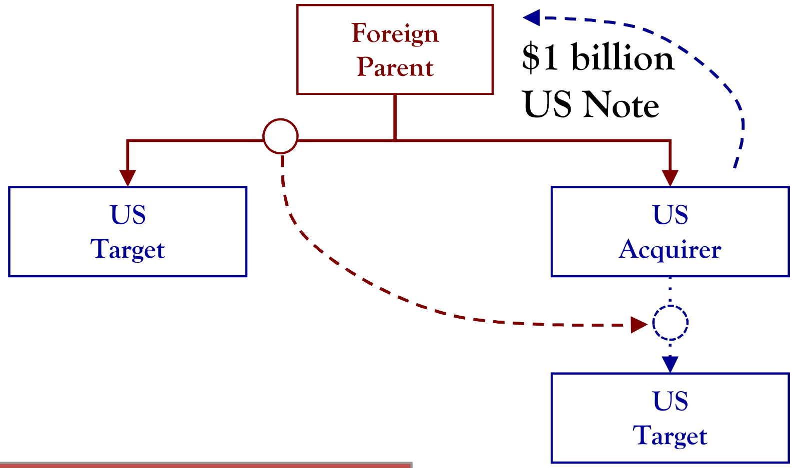
*Recast to §368(a)(1)(E)

D Reorganization with Boot



*Recast to §368(a)(1)(D) with no boot

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



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.

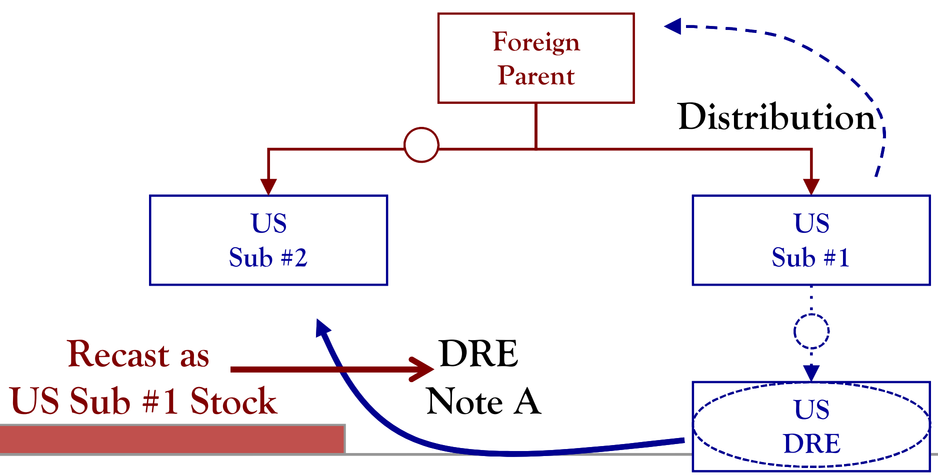
***Funding Rule:**

(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

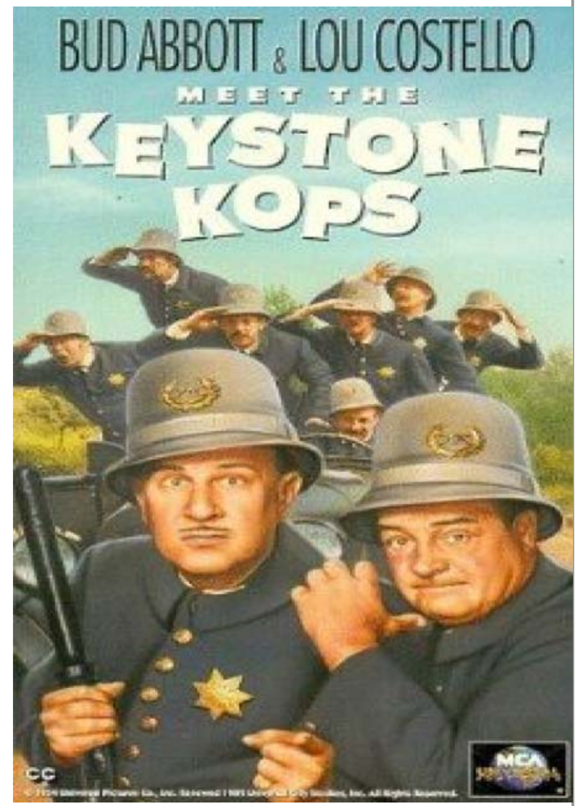
Major Take-Away Items

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
Todd Lowther
Thompson & Knight LLP

Thompson & Knight
ATTORNEYS AND COUNSELORS
Impact®

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

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Mexico Investments to Date - Summary

138 Individually

39 Consortiums

No. of Prequalified Companies

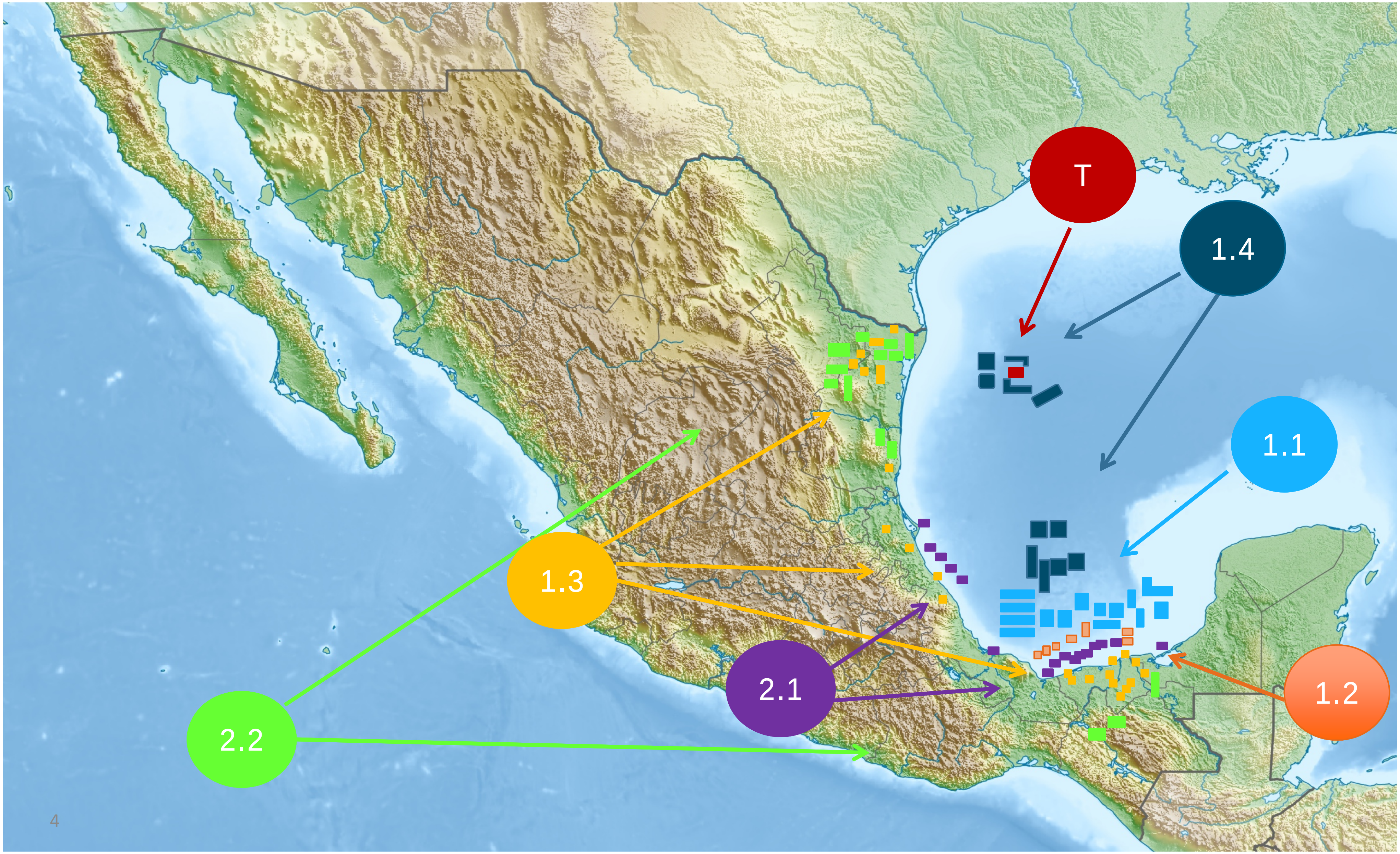
30

Awarded Contracts

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 (**3-4%**)
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

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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

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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

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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".

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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

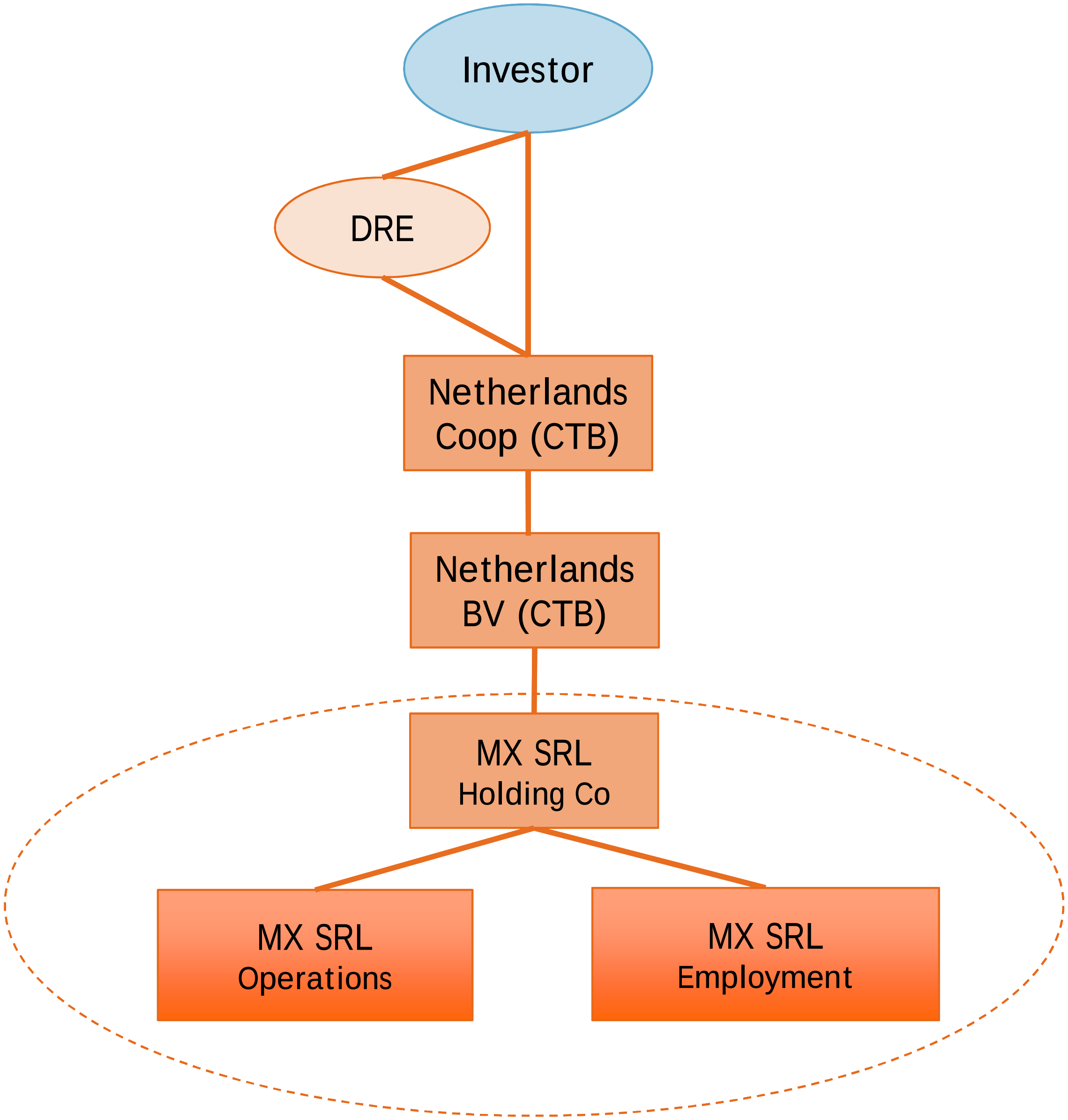
Mexico Tax Treaties – Over 50 in Force

- **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.

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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

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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

Prof. William H. Byrnes, Texas A&M University Law
primary author of Lexis Practical Guide to U.S. Transfer Pricing
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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 it 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 standout, 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

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[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

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[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.

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[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.

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[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 voluntary 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 voluntary 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 regulations[17] and identical cross-referencing proposed regulations[18]

[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

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[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

TEXAS A&M UNIVERSITY
SCHOOL OF LAW

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

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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

BETTER POLICIES FOR BETTER LIVES

Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10
2015 Final Reports

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

OECD

JULY 2010

OECD/G20 Base Erosion and Profit Shifting Project

Transfer Pricing Documentation and Country-by-Country Reporting

ACTION 13: 2015 Final Report

OECD

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

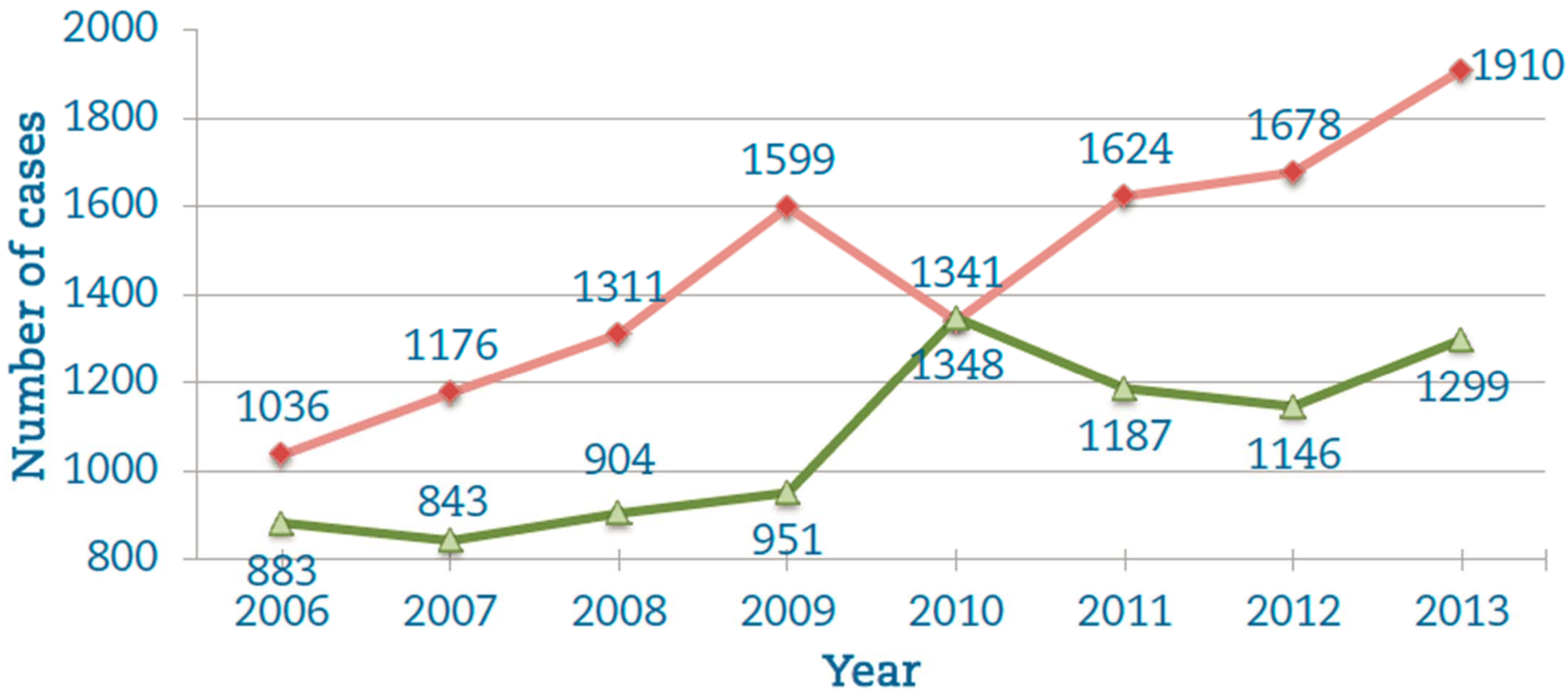
New US CbCR Form 8975

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 profs 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

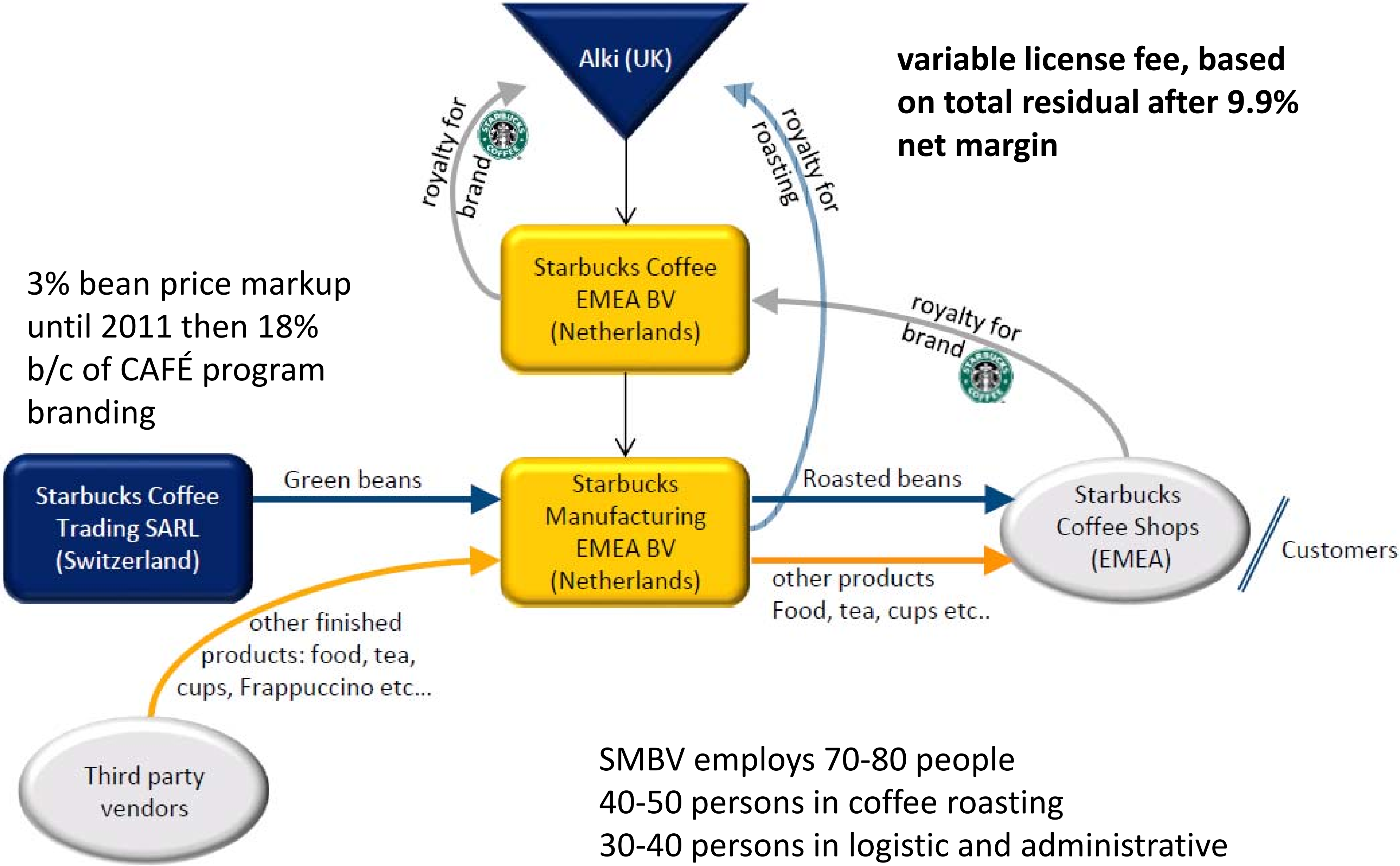
(5) application of the best method rule

State Aid Cases

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

variable license fee, based on total residual after 9.9% net margin

3% bean price markup until 2011 then 18% b/c of CAFÉ program branding



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


European Commission
Starbucks obtained illegal tax advantage from the Netherlands
Unjustified high prices for green beans
Unusual royalty
Sister company
Starbucks Netherlands
Sister company Alki
Very low taxes
Tax administration
Competition

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
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November 3 & 4, 2016

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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 Code[1] 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.

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[1]All 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.

[2]*See* 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.

[8]I.R.C. § 863(b)(2).

[9]I.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. resident[11] 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

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

[11]The 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).

[12]I.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.

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

[14]I.R.C. § 861(c).

[15]I.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:

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[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

[25]I.R.C. § 861(a)(3).

[26]I.R.C. § 862(a)(3).

[27]Treas. 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).

[28]Treas. 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).

[29]Treas. Reg. § 1.861-4(b)(1)(i).

[30]Treas. Reg. § 1.861-4(b)(2)(ii).

[31]Treas. 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

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[32]Treas. 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).

[33]Treas. 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.

[36]I.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

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[37] I.R.C. § 862(a)(4).

[38] T.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).

[39] Treas. Reg. § 1.861-18(f)(2).

[40] I.R.C. § 861(a)(5).

[41] I.R.C. § 862(a)(5).

[42] I.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]

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[43]I.R.C. § 865(g)(1)(A).

[44]I.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).

[45]I.R.C. § 865(g)(1)(B).

[46]I.R.C. § 865(g)(2).

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

[48]I.R.C. § 863(b).

[49]Treas. 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 Code[54] with respect to passage of title in the commercial context, as well as to common law.[55]

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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.]

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

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

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

[53]I.R.C. § 865(e)(2)(B).

[54]State 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).

[55]*See 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

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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).

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

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

[58]Tex. 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 2010[60] 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

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

[60]Pub. L. No. 111-240 (9/27/2010).

[61]Pub. L. No. 111-240, § 2122(d).

[62]I.R.C. § 861(a)(9)(A).

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

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

[65]Joint 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]

[66] I.R.C. § 864(c)(4)(B)(ii).

[67] I.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;

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[68]*See* 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.").

[69]*See, 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]

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[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).

[71]I.R.C. § 875.

[72]I.R.C. § 864(b)(1).

[73]I.R.C. § 864(b)(1).

[74]I.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 FPAAs 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]

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[75]I.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).").

[76]I.R.C. § 864(c).

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

[78]*Ibid*.

[79]I.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.").

[80]I.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 States[87] to which such income, gain, or loss is attributable and such income falls into one of the following three categories:[88]

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[81] Treas. Reg. § 1.864-4(c)(2)(i).

[82] Treas. Reg. § 1.864-4(c)(2)(i).

[83] Treas. Reg. § 1.864-4(c)(3)(i).

[84] Treas. Reg. § 1.864-4(c)(3)(i).

[85] I.R.C. § 864(c)(3).

[86] I.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.).

[88] I.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

[89]I.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).

[90]I.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).

[91]I.R.C. § 864(c)(4)(B)(iii).

[92]I.R.C. § 864(c)(4)(B)(iii).

[93]I.R.C. § 864(c)(4)(A).

[94]I.R.C. § 864(c)(1)(B).

[95]I.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]

[96] I.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

[97]I.R.C. § 7701(b)(1)(B).

[98]I.R.C. § 7701(b)(1)(A).

[99]I.R.C. § 7701(b)(1)(A)(i).

iii) 1/6 of the days in the second preceding calendar year.[100]

(2) Closer Connection Exception to Substantial Presence Test. An individual is not treated as meeting the substantial presence test (and, thus, may be treated as a nonresident alien) if the individual meets a "closer-connection" test. An individual meets the closer connection test if he meets all three of the following conditions:

(a) The individual is present in the U.S. for less than 183 days during the current year;

(b) The individual has a tax home in a foreign country during the current year; and

(c) The individual has a closer connection to a foreign country than to the U.S.[101]

The factors considered in determining whether a person has a closer connection include the location of the person's permanent home, family and personal bank accounts, the location of cultural and religious organizations to which he or she belongs, his or her type of driver's license, and where he or she votes.[102] The closer connection exception will not apply with respect to any current year if the taxpayer had an application for adjustment of status pending with the Immigration and Naturalization Service, or such individual took other steps to apply for status as a lawful permanent resident of the U.S.[103] In order to claim the closer connection exception, a foreign person must timely file a statement with the IRS on I.R.S. Form 8840.[104]

(3) Other Exceptions to Substantial Presence Test. In addition to the closer-connection exception, other exceptions to the substantial presence test are provided for certain medical conditions, foreign-government related individual, teacher or trainee, and students.

2. Treaties. With regard to individuals who reside in countries with whom the U.S. has an income tax treaty, reference should also be made to such treaty. For example, if a green card holder is living in a treaty country, it is possible that the alien will not be treated as a U.S. resident under the treaty's "tie breaker rules."

B. Classification of Entities for Federal Income Tax Purposes.

1. Background. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes.[105] For example, a partnership is defined to

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[100]I.R.C. § 7701(b)(3); *see, e.g., Lujan v. Commissioner,* 80 T.C.M. (CCH) 780 (2000) (alien met substantial presence test for both years in issue).

[101]I.R.C. § 7701(b)(3)(B)(ii).

[102]Treas. Reg. § 301.7701(b)-2(d).

[103]I.R.C. § 7701(b)(3)(C).

[104]Treas. Reg. § 301.7701(b)-8(b)(1)(i).

[105]Treas. Reg. § 301.7701-1(a)(1).

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

[106] I.R.C. § 7701(a)(2).

[107] I.R.C. § 7701(a)(3).

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

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

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

[111] Treas. Reg. § 301.7701-1(a)(1).

[112] Treas. Reg. § 301.7701-1(a)(2).

[113] Treas. 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:

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[114]Treas. 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).

[115]Treas. Reg. § 301.7701-1(a)(4).

[116]Treas. Reg. § 301.7701-2(a).

[117]Treas. 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

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

[121]Treas. Reg.§ 301.7701-2(b)(3).

[122]Treas. Reg. § 301.7701-2(b)(4).

[123]12 U.S.C. § 1811.

[124]Treas. Reg. § 301.7701-2(b)(5).

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

[126]Treas. Reg. § 301.7701-2(b)(7).

[127]Reg. Notice, 1996-1 C.B. at 867.

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

[129]Treas. 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, Hlutafelag
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
Kazakstan, 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

[130]*See* Treas. Reg. § 301-7701-3.
[131]Treas. 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 regulations[139] 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

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

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

[134]Treas. Reg. § 301.7701-2(a).

[135]Treas. Reg. Sec. 301.7701-3(a).

[136]Treas. Reg. Sec. 301.7701-3(a).

[137]Treas. Reg. § 301.7701-3(b)(1)(i).

[138]Treas. 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.").

[139]Treas. Reg. § 301.7701-3(b)(3)(i).

[140]Treas. Reg. § 301.7701-3(b)(3)(i)).

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

[142]Rev. 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 regulations[147] 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]

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[143]Rev. Proc. 2002-69, § 4.01.

[144]Rev. Proc. 2002-69, § 4.02.

[145]Rev. Proc. 2002-69, § 4.03.

[146]Treas. Reg. § 301.7701-3(b)(2).

[147]Treas. Reg. § 301.7701-3(b)(3)(i).

[148]Treas. Reg. § 301.7701-3(b)(3)(i).

[149]Treas. Reg. § 301.7701-3(b)(ii).

[150]Treas. Reg. § 301.7701-3(d)(1).

[151]Treas. Reg. § 301.7701-3(c).

[152]Treas. Reg. § 301.7701-3(c)(1)(i).

[153]Treas. Reg. § 301.7701-3(c)(1)(i).

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

[155]Treas. 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

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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.

[156]Treas. 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.").

[157]*See, 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).

[158]305 F.2d 844, 847 (Ct.Cl. 1962), *cert. denied*, 372 U.S. 968 (1963).

[159]*See 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]

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[160]PLR 200114029 (Apr. 6, 2001).

[161]I.R.C. §§ 7701(a)(4) and (5).

[162]I.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 $600,000[169] (increased for a cost of living adjustment factor for calendar years after 2008 -- $693,000 in 2016[170]). 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

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

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

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

[166]I.R.C. § 877A(a)(2)(A).

[167]I.R.C. § 877A(a)(2)(B).

[168]I.R.C. § 877A(a)(1).

[169]I.R.C. § 877A(a)(3)(A).

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

[171]I.R.C. § 877A(a).

[172]I.R.C. § 2801.

[173]*See* I.R.C. §§ 877A(a)(1), 877A(c).

[174]*See* 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 inflation[175] - $161,000 in 2016[176]); (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 abandoned[179]) 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.

[175]I.R.C. § 877A(a).

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

[177]I.R.C. § 877A(g)(1)(A).

[178]I.R.C. § 877A(g)(1)(B).

[179]I.R.C. § 7701(b)(6).

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

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

[182]Notice 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]

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

[184]I.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.").

[185]I.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....").

[186]I.R.C. §§ 873(a), 882(c).

[187]I.R.C. § 882(c)(1)(A).

[188]I.R.C. § 897.

[189]I.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").

[190]I.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.

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[191] I.R.C. § 884(a).

[192] I.R.C. §§ 1446(a), 1446(b).

[193] I.R.C. § 1446(e).

[194] I.R.C. § 1446(b).

[195] I.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

[196]Treas. Reg. § 1.6012-1(b).

[197]2005-46 I.R.B. 1.

[198]Treas. 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]

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[199]I.R.C. §§ 874(a), 882(c)(2).

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

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

[202]Treas. 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.").

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

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

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

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

[207]I.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;

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

[209] 7 U.S.C. § 3501a).

[210] 7 C.F.R. § 781.3(a); § 781.3(b).

[211] 7 C.F.R. § 781.3(a).

[212] 7 U.S.C. § 3502.

[213] 7 U.S.C. § 3508(3)(C); 7 C.F.R. § 781.2(g).

[214] *See* 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.

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[215] *See* 31 U.S.C. §§ 5311, 5316.

[216] 31 C.F.R. § 1010.340.

[217] 31 C.F.R. § 1010.306(b)(1).

[218] 31 C.F.R. § 1010.306(b)(2).

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

1. Statutory and Regulatory Background. The Bank Secrecy Act[220] 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)

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[220] Titles 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.

[221] 31 U.S.C. § 5311.

[222] 31 C.F.R. § 583 (2011).

[223] 31 U.S.C. § 5314(a).

[224] *See* 31 U.S.C. 5312(a)(1).

[225] *See* 31 U.S.C. 5314(b)(1).

[226] *See* 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]

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[227] 31 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).

[228] 31 C.F.R. § 1010.306(c); *see* Form 114 (Effective Oct. 1, 2013).

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

[230] Department 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.*

[232] 31 C.F.R. § 1010.350(a).

[233] 31 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

[234] 31 C.F.R. § 1010.420.

[235] 31 C.F.R. § 1010.420.

[236] 31 C.F.R. § 1010.350(a).

[237] 31 C.F.R. § 1010.350(b)(1).

[238] 31 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.").

[239] 31 C.F.R. § 1010.350(b)(2).

[240] The 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:

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

[242]31 C.F.R. § 1010.350(c)(1).

[243]31 C.F.R. § 1010.350(c)(2).

[244]31 C.F.R. § 1010.350(c)(3)(i).

[245]31 C.F.R. § 1010.350(c)(3)(ii).

[246]31 C.F.R. § 1010.350(c)(3)(iii).

[247]31 C.F.R. § 1010.350(c)(3)(iv)(A).

[248]31 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

[249]31 C.F.R. § 1010.350(c)(4)(i).

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

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

[252]31 C.F.R. § 1010.350(c)(4)(i).

[253]31 C.F.R. § 1010.350(c)(4)(ii).

[254]31 C.F.R. § 1010.350(c)(4)(iii).

[255]31 C.F.R. § 1010.350(c)(4)(iv).

[256]31 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]

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[257] *Ibid*.

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

[259] 31 C.F.R. § 1010.350(g)(3); BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (Release Date: June 2014).

[260] 31 C.F.R. § 1010.350(e)(1).

[261] 31 C.F.R. § 1010.350(e)(2)(i).

[262] 31 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

[263] 31 C.F.R. § 1010.350(e)(2)(iii).

[264] 31 C.F.R. § 1010.350(e)(2)(iv).

[265] 31 C.F.R. § 1010.350(e)(2)(ii)

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

[267] 31 C.F.R. § 1010.350(f)(1).

[268] 31 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 of 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

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[269] 31 C.F.R. § 1010.350(f)(2)(ii).

[270] 31 C.F.R. § 1010.350(f)(2)(iii).

[271] 31 C.F.R. § 1010.350(f)(2)(iv).

[272] 31 C.F.R. § 1010.350(f)(2)(v).

[273] 31 C.F.R. § 1010.350(g)(5).

[274] 31 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

[275]31 C.F.R. § 1010.350(e)(3).

[276]Pub. L. No. 111-147, 124 Stat. 71.

[277]Hire Act, § 511(c).

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

[279]Treas. Reg. § 1.6038D-2(a)(7)(i).

[280]Instructions to Form 8938 (2015).

[281]Treas. Reg. § 1.6038D-1(a)(1).

[282]Treas. 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 of 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.

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[283]Treas. 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).

[284]Treas. 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.).

[285]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[286]Treas. Reg. § 1.6038D-1(a)(2)(iv).

[287]Notice of Proposed Rulemaking, Fed. Reg. Vol. 76, No. 243, p. 78594 (Dec. 19, 2011).

[288]Preamble, 76 Fed. Reg. 78595 (Dec. 19, 2011).

[289]T.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]

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[295]Treas. Reg. § 1.6038D-2(a)(4); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[296]Treas. Reg. § 1.6038D-2(c)(2).

[297]Treas. Reg. § 1.6038D-2(c)(3)(i).

[298]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011); *see* Treas. Reg. § 1.6038D-2(c)(1)(i).

[299]Temp. Reg. § 1.6038D-2(c)(3)(ii).

[300]2015 Instructions to Form 8938.

[301]Temp. 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

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[302] Temp. Reg. § 1.6038D-5(f)(3)(ii).

[303] I.R.C. § 6038D(b); Temp. Reg. § 1.6038D-3(a); Temp. Reg. § 1.6038D-3(b).

[304] Temp. Reg. § 1.6038D-2(a)(5).

[305] Temp. Reg. § 1.6038D-3(a)(1).

[306] Treas. 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.

[307] Treas. 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).

[308] Treas. 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]

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[309]Treas. Reg. § 1.6038D-3(a)(1).

[310]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[311]Treas. Reg. § 1.6038D-3(a)(3)(i).

[312]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[313]Treas. Reg. § 1.6038D-3(a)(3)(ii).

[314]I.R.C. § 6038D(b)(2)(A); Treas. Reg. § 1.6038D-3(b)(1)(iii).

[315]I.R.C. § 6038D(b)(2)(C); Treas. Reg. § 1.6038D-3(b)(1)(iii).

[316]Treas. 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).

[317]I.R.C. § 6038D(b)(2)(B); Temp. Reg. § 1.6038D-3(b)(1)(ii).

[318]Treas. Reg. § 1.6038D-3(d)(1).

iii) A note, bond, debenture, or other form of indebtedness issued by a foreign person;[320]

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

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[319]Treas. Reg. § 1.6038D-3(d)(2).

[320]Treas. Reg. § 1.6038D-3(d)(3).

[321]Treas. Reg. § 1.6038D-3(d)(4).

[322]Treas. Reg. § 1.6038D-3(d)(5).

[323]Treas. Reg. § 1.6038D-3(d)(6).

[324]Treas. Reg. § 1.6038D-3(b)(3).

[325]Treas. Reg. § 1.6038D-3(b)(4)(i).

[326]Treas. Reg. § 1.6038D-3(b)(4)(ii).

[327]Treas. 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,

[328] Treas. Reg. § 1.6038D-3(b)(5)(i).

[329] Treas. Reg. § 1.6038D-3(b)(5)(ii).

[330] Treas. Reg. § 1.6038D-3(b)(2).

[331] 2015 Instructions to Form 8938.

[332] Treas. Reg. § 1.6038D-2(b)(1).

[333] Treas. 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]

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[334] Treas. Reg. § 1.6038D-2(b)(4)(i).

[335] Treas. Reg. § 1.6038D-2(b)(4)(iii).

[336] Treas. Reg. § 1.6038D-3(c).

[337] I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(1).

[338] I.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

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[339]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(3).

[340]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(4).

[341]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(5).

[342]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(6).

[343]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(7).

[344]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(8).

[345]I.R.C. § 6038D(c)(1); Treas. Reg. § 1.6038D-4(a)(9).

[346]I.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

[347]Treas. Reg. § 1.6038D-2(a)(9); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[348]Treas. Reg. § 1.6038D-2(a)(9); 76 Fed. Reg. 78554 (Dec. 19, 2011).

[349]Treas. Reg. § 1.6038D-2(a)(9); 76 Fed. Reg. 78554 (Dec. 19, 2011).

[350]Treas. Reg. § 1.6038D-2(d)(1).

[351]Treas. Reg. § 1.6038D-2(d)(1)(i).

[352]Treas. Reg. § 1.6038D-2(c)(2).

[353]Treas. Reg. § 1.6038D-2(d)(2).

[354]*See* 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

[355]Treas. Reg. § 1.6038D-2(d).

[356]Treas. Reg. § 1.6038D-2(d).

[357]*See* Treas. Reg. § 1.6038D-7(a)(1)(i).

[358]*See* Treas. Reg. § 1.6038D-7(a)(1)(ii); *see* Form 8938, Part IV.

[359]Treas. 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

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[360]Treas. Reg. § 1.6038D-7(a)(2).

[361]*See* Treas. Reg. § 1.6038D-7(b).

[362]*See* Treas. Reg. § 1.6038D-7(c).

[363]Treas. Reg. § 1.6038D-2(a)(6).

[364]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[365]Treas. Reg. 1.6038D-5(a).

[366]Treas. Reg. § 1.6038D-5b)(1).

[367]Treas. 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

[368]Treas. Reg. § 1.6038D-5(b)(3).

[369]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011); *see* Treas. Reg. § 1.6038D-5(b)(2).

[370]Treas. Reg. § 1.6038D-5(c)(3); Treas. Reg. § 1.6038D-5(c)(4).

[371]Treas. Reg. § 1.6038D-5T(c)(1).

[372]Treas. Reg. § 1.6038D-5(c)(2).

[373]Treas. Reg. § 1.6038D-5(b)(1); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[374]Treas. Reg. § 1.6038D-5(d).

[375]Treas. Reg. § 1.6038D-5(e).

[376]Treas. 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

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[377] Treas. Reg. § 1.6038D-5(f)(1); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[378] Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[379] Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[380] Treas. Reg. § 1.6038D-5(f)(2)(i).

[381] Treas. Reg. § 1.6038D-5(f)(3)(i).

[382] Treas. 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."

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[383] I.R.C. § 6038D(d)(1); Treas. Reg. § 1.6038D-8(a).

[384] I.R.C. § 6038D(d)(2); Treas. Reg. § 1.6038D-8(c).

[385] I.R.C. § 6038D(e); Treas. Reg. § 1.6038D-8(c).

[386] Treas. Reg. § 1.6038D-8(b).

[387] Treas. Reg. § 1.6038D-8(b).

[388] I.R.C. § 6038D(e); Treas. Reg. § 1.6038D-8(d).

[389] I.R.C. § 6038D(g); Treas. Reg. § 1.6038D-8(e)(1).

[390] Treas. Reg. § 1.6038D-8(e)(2).

[391] I.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]

[392]Prop. Treas. Reg. § 1.6038-4(a); Prop. Treas. Reg. § 1.6038-4(h).

[393]Prop. 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 business[395] ***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.

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[394] I.R.C. § 884(a); Treas. Reg. § 1.884-1(a).

[395] I.R.C. §884(b); Treas. Reg. § 1.884-1(b)(1).

[396] I.R.C. § 884(d)(2)(A); Treas. Reg. § 1.884-1(f)(2)(i).

[397] I.R.C. § 884(d)(2)(C); Treas. Reg. § 1.884-1(f)(2)(iii).

[398] I.R.C. § 884(d)(2)(E); Treas. Reg. § 1.884-1(f)(2)(vi).

[399] I.R.C. § 884(d)(2)(D); Treas. Reg. § 1.884-1(f)(2)(iv).

[400] I.R.C. § 884(b); Treas. Reg. § 1.884-1(b)(2).

[401] I.R.C. §§ 884(b)(1), 884(c); Treas. Reg. § 1.884-1(b)(2).

[402] I.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]

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[403] I.R.C. § 884(f)(1)(A); Treas. Reg. § 1.884-4(a)(1).

[404] I.R.C. § 884(f)(1)(B); Treas. Reg. § 1.884-4(a)(2).

[405] I.R.C. §§ 884(f)(1)(B), 884(f)(2); Treas. Reg. § 1.884-4(a)(2)(i).

[406] I.R.C. § 884(e)(1); Treas. Reg. § 1.884-5.

[407] I.R.C. § 884(e)(4)(A)(i); Treas. Reg. § 1.884-5.

[408] I.R.C. § 884(e)(4)(A)(ii); Treas. Reg. § 1.884-5.

[409] *See* I.R.C. § 884(e)(3)(B).

[410] Temp. Reg. § 1.884-2T(a).

[411] *See 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

[412]I.R.C. §§ 871(a), 871(b), 881(a), 882(a)(1).

[413]I.R.C. § 1441(c)(1).

[414]I.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).

[415]I.R.C. §§ 871(a)(1)(A) and 881(a)(1).

[416]I.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).

[417]I.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

[418]I.R.C. §§ 871(a)(1)(A), 881(a)(1).

[419]I.R.C. § 1273(a)(1).

[420]I.R.C. §§ 871(a)(1)(C), 881(a)(3).

[421]I.R.C. §§ 871(g)(1)(A), 881(e).

[422]I.R.C. §§ 1272(a)(1), 1272(d)(2).

[423]Staff of the Joint Comm. On Taxation, 98th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1984*, 402 403 (1984).

[424]I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

[425]I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

[426]I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

[427]I.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

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[428] I.R.C. §§ 871(a)(1)(C)(i), 881(a)(3)(A).

[429] I.R.C. § 871(g)(1)(B)(i).

[430] I.R.C. § 871(g)(1)(B)(ii).

[431] I.R.C. §§ 871(i)(1), 871(i)(2)(A), 871(i)(3).

[432] I.R.C. § 871(h)(1); *see* Treas. Reg. § 1.871-14(a).

[433] I.R.C. § 881(c)(1); Treas. Reg. § 1.871-14(b).

[434] I.R.C. § 871(h)(2).

[435] Pub. L. No. 111-144, § 502(b)(1) 124 Stat. 42.

[436] See 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 form[438] 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]

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[437] I.R.C. §§ 871(h)(2)(A), 881(c)(2)(A), 163(f)(2)(B); *see* Treas. Reg. § 1.871-14(b)(1).

[438] I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B); *see* Treas. Reg. § 1.871-14(c)(1)(i).

[439] I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B); *see* Treas. Reg. § 1.871-14(c)(1)(ii)(C).

[440] *See* Treas. Reg. § 1.871-14(e)(1).

[441] I.R.C. § 871(h)(2); Treas. Reg. § 1.871-14(a).

[442] Treas. Reg. § 1.871-14(b)(1).

[443] I.R.C. § 871(h)(3)(B)(i).

[444] I.R.C. § 871(h)(3)(B)(ii).

[445] I.R.C. § 881(c)(3).

[446] I.R.C. § 881(c)(3).

[447] I.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 treaty[452]).[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

[448] I.R.C. §§ 871(i)(2)(B), 881(d).

[449] I.R.C. § 861(c)(1).

[450] I.R.C. §§ 871(a)(1)(B), 881(a)(2).

[451] I.R.C. §§ 871(a)(1)(D), 881(a)(4).

[452] *See* Treas. Reg. § 1.1441-6.

[453] I.R.C. § 1441(a).

[454] I.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

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[455]Treas. 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).

[456]Treas. Reg. § 1.1441-2(b).

[457]Treas. Reg. § 1.1441-2(b)(2)(i).

[458]Treas. Reg. § 1.1441-5(b)(1).

[459]I.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

[460]Treas. Reg. § 1.1441-5(b)(2)(i).

[461]Treas. Reg. § 1.1441-5(b)(2)(i).

[462]Treas. Reg. § 1.1441-5(b)(2)(v).

[463]Treas. Reg. § 1.1441-5(c)(1).

[464]Treas. Reg. § 1.1441-5(c)(1)(ii).

[465]*See* Treas. Reg. § 1.1441-3(c)(1).

[466]Treas. Reg. § 1.1441-3(c)(1).

[467]Treas. 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.

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[468]Treas. Reg. § 1.1441-3(c)(2)(ii)(B).

[469]Treas. Reg. § 1.1441-1(b)(4)(v).

[470]I.R.C. § 1441(c)(1); Treas. Reg. § 1.1441-4(a)(1).

[471]Treas. Reg. § 1.1441-4(a)(2).

[472]I.R.C. § 864(b).

[473]Treas. 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).

[474]Treas. Reg. § 1.1441-4(b)(1).

[475]I.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.

[476]Treas. 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).

[477]Treas. Reg. § 1.1461-1(c)(1).

[478]Treas. Reg. § 1.1461-1(c)(2).

[479]Treas. Reg. § 1.1461-1(c)(1)(i).

[480]I.R.C. § 1462.

[481]Treas. 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.").

[482]Treas. 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 thereon[483] 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 2010[488] (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

[483] I.R.C. § 871(a)(2)(A).

[484] Treas. Reg. § 1.6049-8.

[485] 2014-64, 2014-53 I.R.B. 1022.

[486] 2015-42 IRB 583.

[487] 2016-17 IRB 635.

[488] Pub. L. No. 111-147, 124 Stat.71.

[489] *See generally* I.R.C. Sec. 1471.

[490] I.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.
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> 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

[491] See I.R.C. Sec. 1472(b).

[492] *See* "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]

[493] *See* “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 reciprocal[494] and nonreciprocal versions[495]) 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]

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[494]*See* "FATCA Reciprocal Model Agreement Available," 2012 TNT 145-28.

[495]*See* "FATCA Nonreciprocal Model Agreement Available," 2012 TNT 145-29.

[496]Ann. 2012-42, 2012 TNT 207-9.

[497]*See* "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.

[498]*See* "Mexico-U.S. FATCA Agreement is Available," 2012 TNT 229-43.

[499]*See* "U.S., Mexico Sign FATCA Agreement," 2012 TNT 229-4.

[500] T.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

[501]*See* I.R.C. §§ 871(d)(1), 882(d)(1).

[502]I.R.C. §§ 871(d)(1)(A), 882(d)(1)(A).

[503]Treas. 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).").

[504]Treas. Reg. § 1.871-10(e)(1).

[505]I.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

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[506] I.R.C. § 897.

[507] I.R.C. § 897(b).

[508] I.R.C. § 897(a)(2)(A).

[509] I.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).

[510] Treas. Reg. § 1.897-1(b)(1).

[511] Treas. Reg. § 1.897-1(d)(2)(i).

[512] *See* Treas. Reg. § 1.897-1(d)(2)(i); Treas. Reg. § 1.897-1(d)(2)(ii)(B).

[513] Treas. Reg. § 1.897-1(d)(2)(i).

[514] Treas. 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

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[515] I.R.C. § 897(c)(2).

[516] I.R.C. § 897(c)(4)(B).

[517] I.R.C. § 897(c)(5).

[518] Treas. Reg. § 1.897-2(b); Treas. Reg. § 1.897-2(f).

[519] Treas. Reg. § 1.897-2(b)(2); *see* Treas. Reg. § 1.897-1(o) for methods of determining the fair market value of assets.

[520] I.R.C. § 897(g).

[521] Treas. Reg. § 1.897-7T.

[522] I.R.C. § 897(g).

[523] I.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

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[524]Staff of the Joint Comm. on Taxation, 104th Cong., 2d Sess., *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS-5-96) (1996).

[525]I.R.C. § 897(j).

[526]I.R.C. § 897(i).

[527]I.R.C. § 897(i)(3)(A).

[528]I.R.C. § 897(i)(4).

[529]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.

[530]I.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]

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[531]Treas. Reg. § 1.1445-1(g)(5).

[532]Treas. Reg. § 1.1445-1(c)(1).

[533]Treas. Reg. § 1.1445-1(c)(2)(i)(B).

[534]I.R.C. §§ 1461, 6672; Treas. Reg. § 1.1445-1(e).

[535]Treas. Reg. § 1.1445-1(e)(3)(ii).

[536]Treas. Reg. § 1.1445-1(e)(3)(iii).

[537]I.R.C. § 1445(b)(5).

[538]Treas. Reg. § 1.1445-2(d).

[539]I.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 sales[543] 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

[540] I.R.C. §§ 1445(b)(3), 1445(b)(7).

[541] I.R.C. §§ 1445(b)(2), 1445(b)(7).

[542] *See* Treas. Reg. § 1445-1(b)(3).

[543] *See* Treas. Reg. § 1.1445-2(d)(4); Rev. Proc. 2000-35, 2002-2 C.B. 211.

[544] *See* Treas. Reg. § 1.1445-2(d)(3).

[545] I.R.C. § 1445(e)(1).

[546] I.R.C. § 1445(e)(2).

[547] I.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]

[548]T.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 employers[550] and employees[551] 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]

[550]*See* I.R.C. § 3111.

[551]*See* I.R.C. § 3101.

[552]I.R.C. § 3101(a); P.L. 111-312, §§ 601(a)(2), 601(c) (as amended by P.L. 112-96, § 1001(a)).

[553]SSA Notice, 80 Fed. Reg. 66,693 (Oct. 30, 2015).

[554]I.R.C. § 3101(b)(2).

[555]I.R.C. § 3121(a).

[556]I.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 thereafter[567]) of the taxable wages paid by the employer during the calendar year.[568] The FUTA tax applies to the

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[557]Rev. Rul. 92-106, 1992-2 C.B. 258, 260.

[558]*Ibid.*

[559]I.R.C. § 3121(b)(11).

[560]I.R.C. § 3121(b)(19).

[561]I.R.C. § 3121(b)(15).

[562]I.R.C. § 3121(b)(19).

[563]I.R.C. § 3121(b)(19).

[564]I.R.C. § 3121(b)(19).

[565]I.R.C. § 3121(b)(19); *see* Treas. Reg. § 31.3121(b)(19)-1(a)(1).

[566]I.R.C. § 3301.

[567]I.R.C. § 3301(2) (as amended by P.L. 111-92, § 10(a).

[568]I.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]

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[569] *See* I.R.C. § 3306(b).

[570] *See* 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.

[571] I.R.C. § 3306(b).

[572] I.R.C. § 3306(c).

[573] Rev. Rul. 92-106, 1992-2 C.B. at 260.

[574] *Ibid.*

[575] I.R.C. § 3306(c)(19).

[576] I.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:

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[577] Staff 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

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[578] *Joint Committee Treaty Report* at 36-37.

[579] *Joint Committee Treaty Report* at 38.

[580] *Joint Committee Treaty Report* at 37.

[581] *Joint Committee Treaty Report* at 38.

[582] I.R.C. § 6114.

[583] Treas. Reg. § 301.6114-1(a)(1)(i).

[584] Treas. Reg. § 301.6114-1(a)(ii).

[585] Ann. 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 7582(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]

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[586]I.R.C. § 6712; Treas. Reg. § 301.6712-1(a).

[587]I.R.C. § 6712; Treas. Reg. § 301.6712-1(b).

[588]U.S. Const., art. 2, § 2(2).

[589]U.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).

[590]Staff 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).*

[591]T.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

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[592]Treas. Reg. § 1.881-3(a)(1).

[593]Treas. Reg. § 1.881-3(a)(1).

[594]Treas. Reg. § 1.881-3(a)(2)(ii).

[595]Treas. Reg. § 1.881-3(a)(2)(i)(A).

[596]Treas. Reg. § 1.881-3(a)(3)(ii)(A).

[597]*See* 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]

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[598]Treas. 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.

[601]56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B. 1.

[602]115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995).

[603]U.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]

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[604] U.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]

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[605] I.R.C. §§ 2101(a), 2103, 2501(a)(1), 2511.

[606] Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-1(b).

[607] Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-1(b)..

[608] I.R.C. § 2103.

[609] Treas. Reg. § 20.2104-1(a)(1).

[610] Treas. Reg. § 20.2104-1(a)(2).

[611] I.R.C. § 2104(a); Treas. Reg. § 20.2104-1(a)(5).

[612] I.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]

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[613]*See* 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).

[614]Treas. Reg. § 20.2105-1(a)(1).

[615]Treas. Reg. § 20.2105-1(a)(2).

[616]I.R.C. § 2105(a).

[617]I.R.C. §§ 2105(b), 871(i)(3).

[618]Treas. Reg. § 20.2105-1(f).

[619]I.R.C. § 2105(b)(3).

[620]I.R.C. § 2105(b)(4).

[621]I.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.

[622] I.R.C. § 2102(c)(1).

[623] I.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

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[625]*See 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]

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[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]

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[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; s*ee 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]

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[680] 70 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.

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[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]

[695] *See 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 1989[696] 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.

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[696]The Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106,

[697]H.R. Rep. No. 247, 101st Cong., 1st Sess. 1240-1250 (1989), *reprinted in* 1989 U.S.C.C.A.N. 2710-2720.

[698]Congressional Committee Reports; Notice of Proposed Rulemaking INTL-0870-89 (June 12, 1991).

[699]H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 63-71 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018.

[700]Notice of Proposed Rulemaking INTL-0870-89 (June 12, 1991).

[701]H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 631 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1320.

[702]I.R.C. § 163(j)(3)(B), 163(j)(6)(D)(i); H.R. Conf. Rep. No. 213, *supra* at n. 475.

[703]I.R.C. § 163(j)(6)(D)(ii); H.R. Conf. Rep. No. 213, *supra* at n. 475.

[704]I.R.C. § 163(j)(3)(C); S. Rep. No. 201, 106th Cong., 1st Sess. (1999).

[705]I.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

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[706] I.R.C. § 163(j)(2)(A)(ii).

[707] I.R.C. § 163(j)(1)(A).

[708] I.R.C. §§ 163(j)(2)(A)(i), 163(j)(2)(B)(i).

[709] I.R.C. § 163(j)(2)(A)(ii); *cf.* Prop. Reg. § 1.163(j)-1(b).

[710] I.R.C. § 163(j)(2)(C); *cf.* Prop. Reg. § 1.163(j)-3(a).

[711] Prop. Reg. § 1.163(j)-3(b)(1).

[712] Prop. Reg. § 1.163(j)-3(b)(2).

[713] I.R.C. § 163(j)(2)(C); *Cf.* Prop. Reg. § 1.163(j)-3(c)(1).

[714] Prop. Reg. § 1.163(j)-3(c)(3).

[715] I.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

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[716]I.R.C. § 163(j)(3)(B)(i).

[717]I.R.C. § 163(j)(4)(B)(ii).

[718]*See* H.R. Rep. No. 111, 103rd Cong., 1st Sess. 680-687 (1993), *reprinted in* 1993 U.S.C.C.A.N. 911-918.

[719]I.R.C. § 163(j)(4)(A).

[720]I.R.C. § 163(j)(4)(B)(i).

[721]I.R.C. §§ 163(j)(2)(A)(i), 163(j)(2)(B)(i).

[722]I.R.C. § 163(j)(6)(B).

[723]I.R.C. § 163(j)(6)(A).

[724]I.R.C. § 163(j)(2)(B)(iii)(I).

[725]I.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 1.163(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)).

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[726] I.R.C. § 163(j)(2)(B)(ii).

[727] I.R.C. § 163(j)(6)(C).

[728] *See* Prop. Reg. § 1.163(j)-5.

[729] Notice of Proposed Rulemaking, Reg-2090S9-89 [originally issued as INTL-0870-89] published June 13, 1991 (CCH 49,161).

[730] I.R.C. § 163(j)(1)(A).

[731] I.R.C. § 163(j)(1)(B); Prop. Reg. §§ 1.163(j)-1(a)(3), 1.163(j)-1(c)(1).

[732] H.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]

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[733]H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

[734]H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

[735]I.R.C. § 163(j)(5)(B).

[736]H.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]

[737]Treas. Reg. § 1.267(a)-3(b)(1).

[738]Treas. 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;

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[739]I.R.C. § 951(a).

[740]I.R.C. § 951(a)(1)(A)(i).

[741]I.R.C. § 951(a)(1)(B).

[742]I.R.C. § 951(a)(1).

[743]I.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.").

[744]I.R.C. § 951(b); *see also* Treas. Reg. § 1.951-1(b)(2) ("combined voting power" defined).

[745]I.R.C. §§ 958(a), 958(b).

[746]I.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

[747] I.R.C. § 952(a)(5); I.R.C. § 901(j).

[748] I.R.C. § 952(b).

[749] I.R.C. § 952(c)(1)(A).

[750] I.R.C. § 954(a) (as amended by the American Jobs Creation Act of 2004).

[751] I.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.

[752]I.R.C. § 954(b)(3)(B).

[753]I.R.C. § 954(b)(4).

[754]I.R.C. § 954(b)(5).

[755]I.R.C. § 275(a)(1).

[756]I.R.C. § 954(c)(1).

[757]I.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

[758]I.R.C. § 954(d)(1)(A).

[759]I.R.C. § 954(d)(1)(B).

[760]I.R.C. § 954(d)(2).

[761]Treas. Reg. § 1.954-3(b)(1)(ii).

[762]I.R.C. § 954(e)(1)(A).

[763]I.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

[764]I.R.C. § 954(e).

[765]I.R.C. § 954(g)(1).

[766]I.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

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[767] I.R.C. § 954(g)(2).

[768] I.R.C. § 956(a).

[769] I.R.C. § 956(a).

[770] I.R.C. § 956(c)(2)(F).

[771] I.R.C. § 956(c)(1)(C).

[772] I.R.C. § 956(d).

[773] Treas. Reg. § 1.956-2(c)(2).

[774] I.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;" <u>or</u> (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:

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[775] I.R.C. § 956(c)(3).

[776] See Rev. Proc. 90-26, 1990-1 C.B. 512 (guidance provided with respect to the required tax year under Section 898).

[777] I.R.C. § 1291.

[778] *See* I.R.C. §§ 1291-1297.

[779] I.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).

[780] I.R.C. § 1297(a).

[781] I.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]

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[782] I.R.C. § 1291(a)(1).

[783] I.R.C. § 1291(b)(1), (2).

[784] I.R.C. § 1291(b)(2)(B).

[785] I.R.C. § 1293(a).

[786] I.R.C. § 1293(a)(1).

[787] I.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]

[788] *See* Treas. Reg. § 1.532-1(c).

[789] I.R.C. § 535(b).

[790] *See*, *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

[791] I.R.C. §§ 275(a), 901.

[792] I.R.C. § 901(b).

[793] I.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).

[794] I.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:

Pre-credit U.S. tax X <u>Foreign source taxable income</u>

[795] Treas. Reg. § 1.901-2(a)(2)(i).

[796] Treas. Reg. § 1.901-2(a)(1).

[797] Treas. 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).

[798] Treas. Reg. § 1.903-1(a).

[799] Treas. Reg. § 1.903-1(b).

[800] Treas. 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.

Worldwide taxable income[802]

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?

[802] I.R.C. § 904(a).

[803] I.R.C. § 904(d).

[804] I.R.C. § 904(f)(5)(A).

[805] I.R.C. § 904(f)(5)(B).

[806] I.R.C. § 904(f)(5)(C).

[807] I.R.C. § 904(f).

[808] I.R.C. § 904(f).

[809] I.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]

[810]I.R.C. § 905; Treas. Reg. § 1.905-1(a).

[811]Treas. 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:

$$\frac{\text{Dividend received by the U.S. shareholder}}{\text{Post-1986 undistributed earnings of foreign corporation}} \text{ X } \text{Post-1986 foreign income taxes paid and deemed paid by first-tier foreign corporation} = \text{Amount of first-tier foreign corporation's foreign income taxes deemed paid by domestic corporation}$$[813]

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

[812] I.R.C. § 902(a).

[813] I.R.C. § 902(a).

[814] I.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).

[815] I.R.C. § 902(c)(2).

[816] I.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]

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[817] I.R.C. § 902(b)(2)(B).

[818] I.R.C. § 960.

[819] I.R.C. § 78.

[820] I.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 corporation[825] 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]

[821] I.R.C. § 367(a)(1).

[822] Temp. Treas. Reg. § 1.367(a)-1T(b)(1).

[823] Temp. Treas. Reg. § 1.367(a)-1T(b)(3)(ii).

[824] Temp. Treas. Reg. § 1.367(a)-1T(b)(4).

[825] I.R.C. § 367(a)(2).

[826] I.R.C. § 367(a)(3)(A).

[827] I.R.C. § 367(a)(3)(B).

[828] I.R.C. § 367(d).

[829] I.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]

[830] I.R.C. § 367(f).

[831] I.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]

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[832]I.R.C. § 482.

[833]Treas. Reg. § 1.482-1(a)(1).

[834]Treas. Reg. § 1.482-1(a)(2).

[835]Treas. Reg. § 1.482-1(f)(1)(i).

[836]Treas. Reg. § 1.482-1(f)(1)(iv).

[837]Treas. 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.

[838] Treas. Reg. § 1.482-1(b)(1).

[839] Treas. Reg. § 1.482-1(b)(2).

[840] Treas. 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]

[841] I.R.C. § 1059A(a).

[842] Treas. 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]

[843] I.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 acquisition[846]).[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]

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[844] I.R.C. § 7874(a)(2)(A).

[845] I.R.C. § 7874(a)(2)(B)(i).

[846] I.R.C. § 7874(c)(2).

[847] I.R.C. § 7874(a)(2)(B)(ii).

[848] I.R.C. 7874(a)(2)(B)(iii).

[849] I.R.C. § 7874(a)(1).

[850] I.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.

[851] I.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

[852]I.R.M. 9.5.11.9(1).

[853]I.R.M. 9.5.11.9(2).

[854]I.R.M. 9.5.11.9(3).

[855]I.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).

[856] 2009 OVDP, Q&A No. 2.

[857] 2009 OVDP, Q&A No. 4.

U.S. International Taxation

International Tax Symposium

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November 3, & 4, 2016

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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	

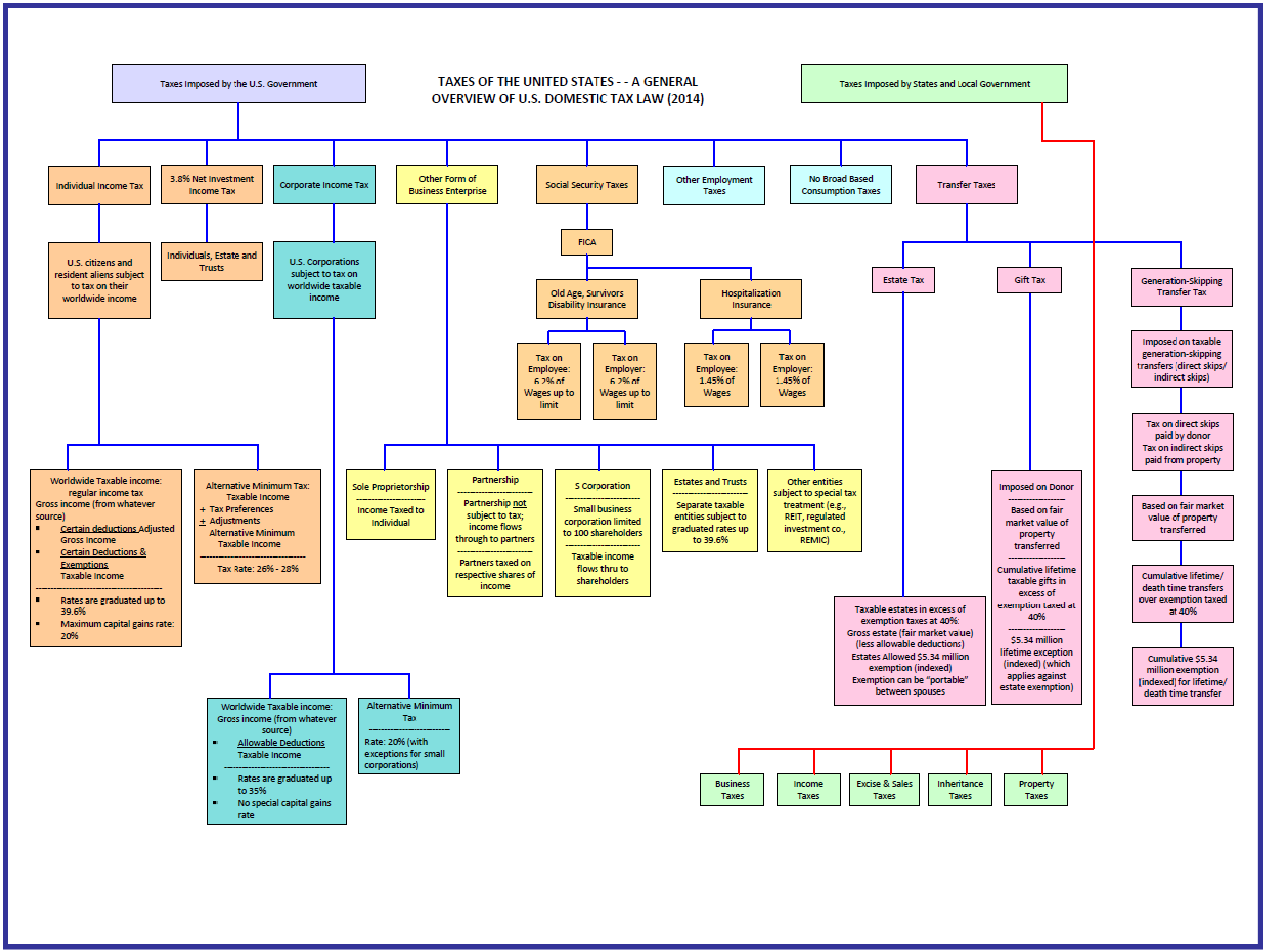
Overview of Types of U.S. Immigrant Visas

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

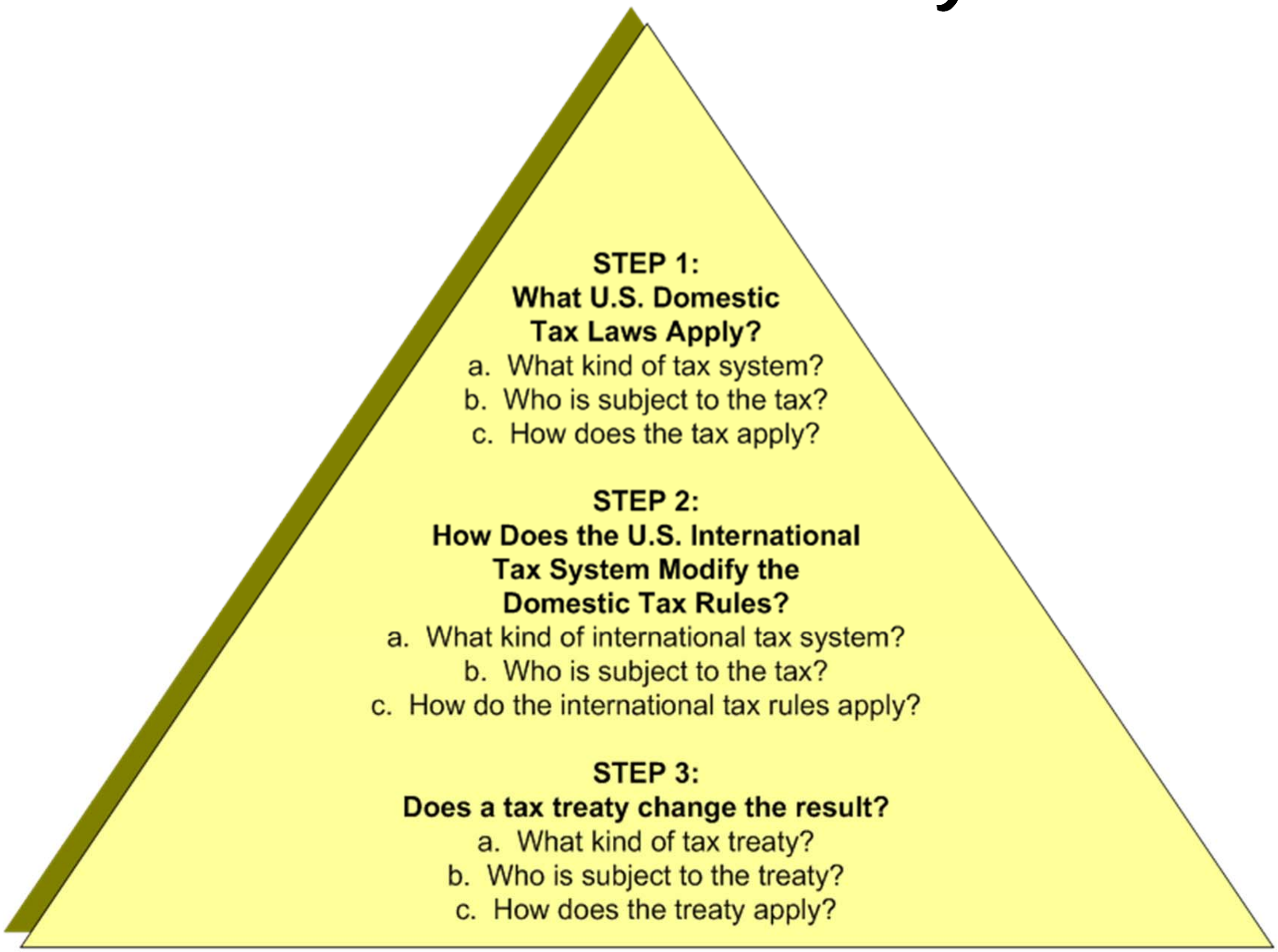
Source: http://travel.state.gov/content/visas/english/general/all-visa-categories.html

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
Individual Income Tax
3.8% Net Investment Income Tax
Corporate Income Tax
Other Form of Business Enterprise
Social Security Taxes
Other Employment Taxes
No Broad Based Consumption Taxes
Transfer Taxes
U.S. citizens and resident aliens subject to tax on their worldwide income
Individuals, Estate and Trusts
U.S. Corporations subject to tax on worldwide taxable income
FICA
Old Age, Survivors Disability Insurance
Hospitalization Insurance
Tax on Employee: 6.2% of Wages up to limit
Tax on Employer: 6.2% of Wages up to limit
Tax on Employee: 1.45% of Wages
Tax on Employer: 1.45% of Wages
Estate Tax
Gift Tax
Generation-Skipping Transfer Tax
Imposed on taxable generation-skipping transfers (direct skips/ indirect skips)
Tax on direct skips paid by donor Tax on indirect skips paid from property
Based on fair market value of property transferred
Cumulative lifetime/ death time transfers over exemption taxed at 40%
Cumulative $5.34 million exemption (indexed) for lifetime/ death time transfer
Worldwide Taxable income: regular income tax Gross income (from whatever source) ▪ Certain deductions Adjusted Gross Income ▪ Certain Deductions & Exemptions Taxable Income ▪ Rates are graduated up to 39.6% ▪ Maximum capital gains rate: 20%
Alternative Minimum Tax: Taxable Income + Tax Preferences ± Adjustments Alternative Minimum Taxable Income Tax Rate: 26% - 28%
Sole Proprietorship Income Taxed to Individual
Partnership Partnership not subject to tax; income flows through to partners Partners taxed on respective shares of income
S Corporation Small business corporation limited to 100 shareholders Taxable income flows thru to shareholders
Estates and Trusts Separate taxable entities subject to graduated rates up to 39.6%
Other entities subject to special tax treatment (e.g., REIT, regulated investment co., REMIC)
Imposed on Donor Based on fair market value of property transferred Cumulative lifetime taxable gifts in excess of exemption taxed at 40% $5.34 million lifetime exception (indexed) (which applies against estate exemption)
Taxable estates in excess of exemption taxes at 40%: Gross estate (fair market value) (less allowable deductions) Estates Allowed $5.34 million exemption (indexed) Exemption can be "portable" between spouses
Worldwide Taxable income: Gross income (from whatever source) ▪ Allowable Deductions Taxable Income ▪ Rates are graduated up to 35% ▪ No special capital gains rate
Alternative Minimum Tax Rate: 20% (with exceptions for small corporations)
Business Taxes
Income Taxes
Excise & Sales Taxes
Inheritance Taxes
Property Taxes

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; <u>AND</u>

      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.

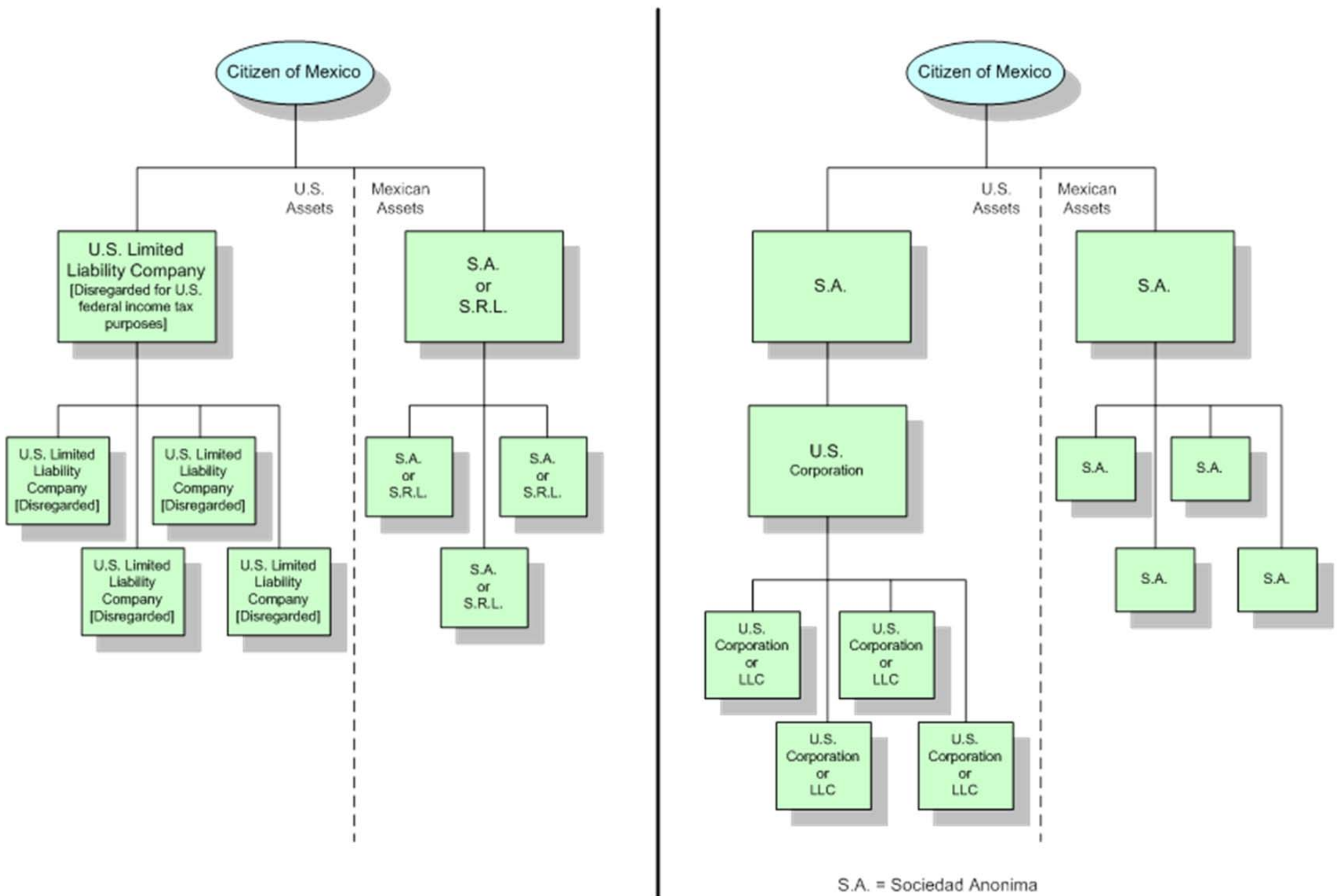
1. General Statutory Authority for FICA Tax Liabilities
2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.
   a. Wages Paid by U.S. Person/Employer
   b. Wages Paid by Foreign Person/Employer
3. Exception to Liability for Persons in Certain Visa Categories
4. Impact of Totalization 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

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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

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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

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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

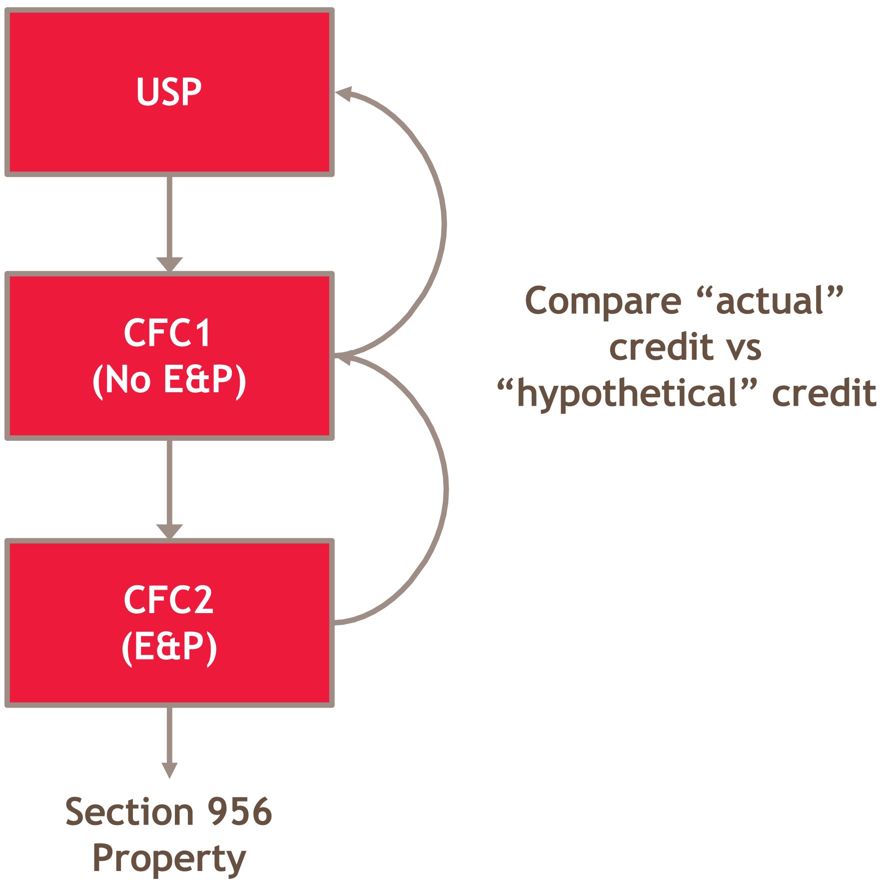
Foreign Tax Credit Basics

Is my foreign tax creditable?

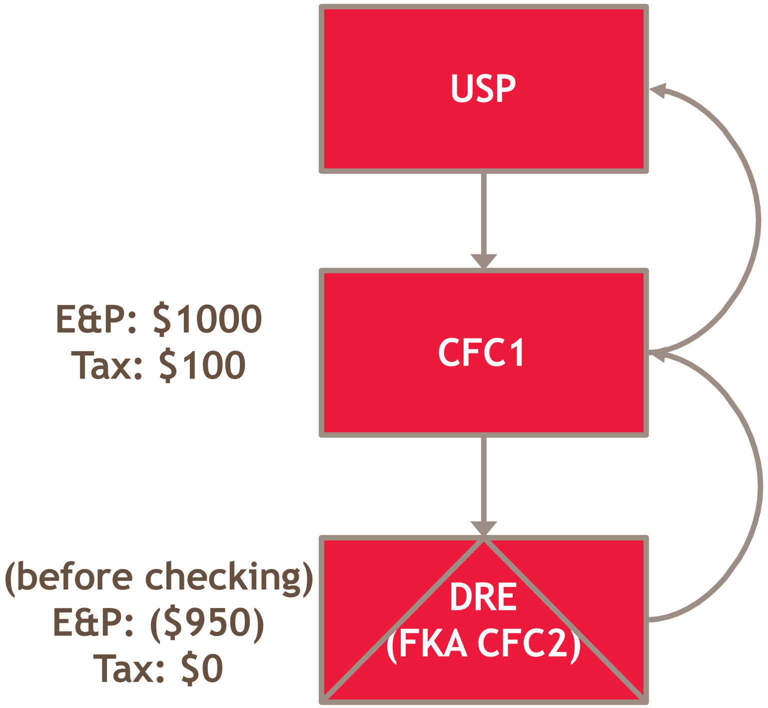
Consider:

- 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 x $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:

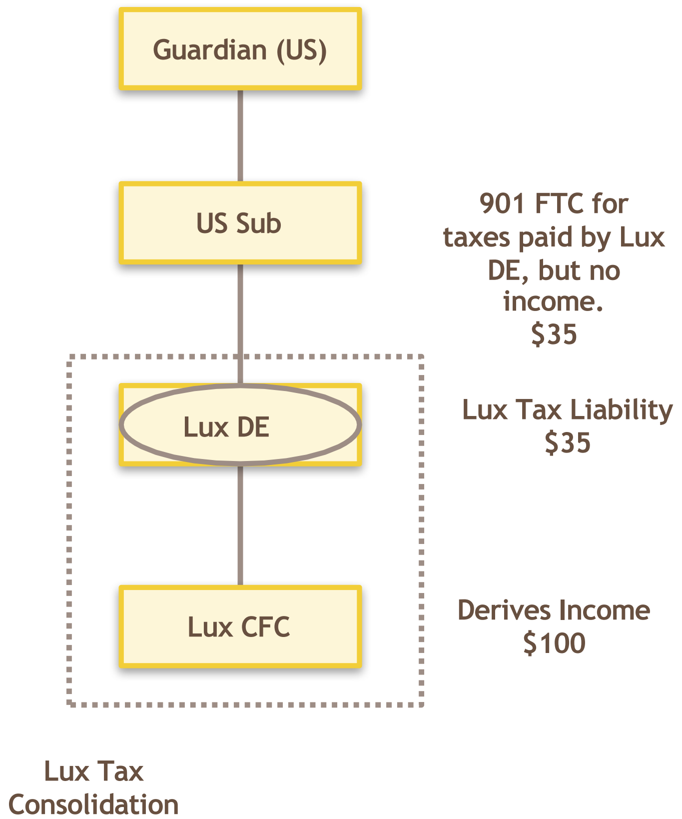
- §901 taxes – suspended until US shareholder recognizes the income
- §902/960 taxes – suspended until the CFC that accrued the foreign taxes recognizes the income or the US shareholder recognizes the income
- Deductions for taxes is also deferred (including for E&P purposes)

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.

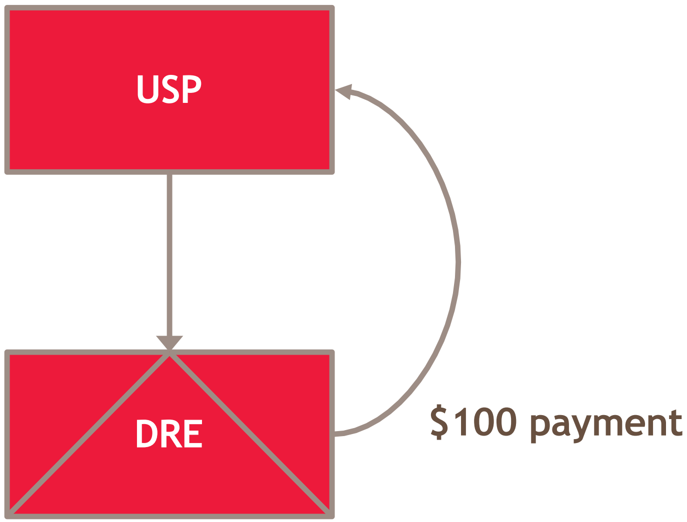
Held

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 asses 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 FEs 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:
    - U.K. company; or
    - 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").

PROFESSIONAL AFFILIATIONS

State Bar of Texas, Tax Section; Chair, International Tax Committee; Chair, Annual Meeting Committee
Dallas Bar Association, Tax Section
American Bar Association, Tax Section

EDUCATION

LLM in Taxation, Northwestern University School of Law
JD, Southern Methodist University

Questions?

International Estate Planning Update

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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 a 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)

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

Related Topics

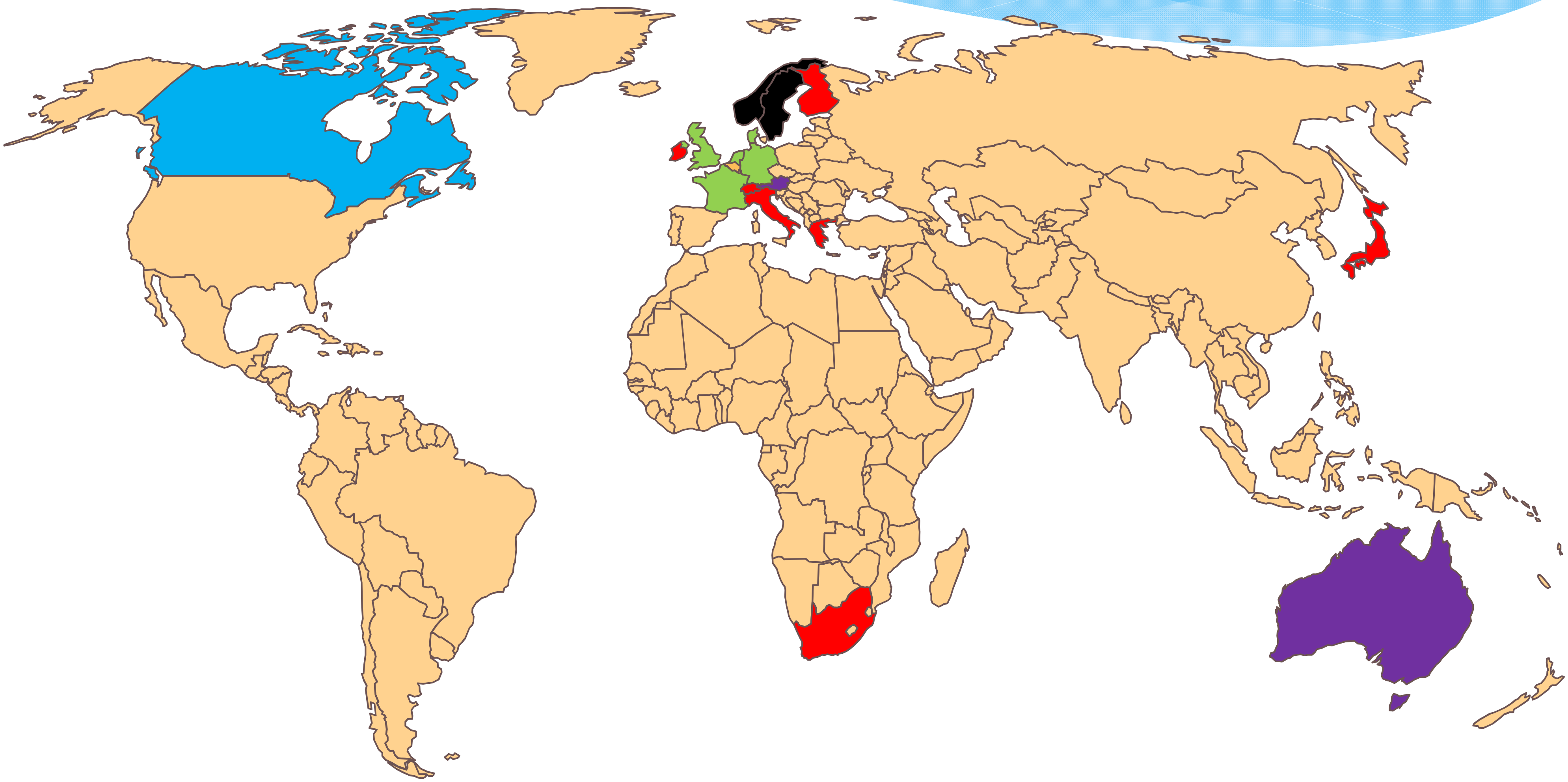
› Estate and Gift Taxes

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.

Form 5472

* **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.

Form 5472

* **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.

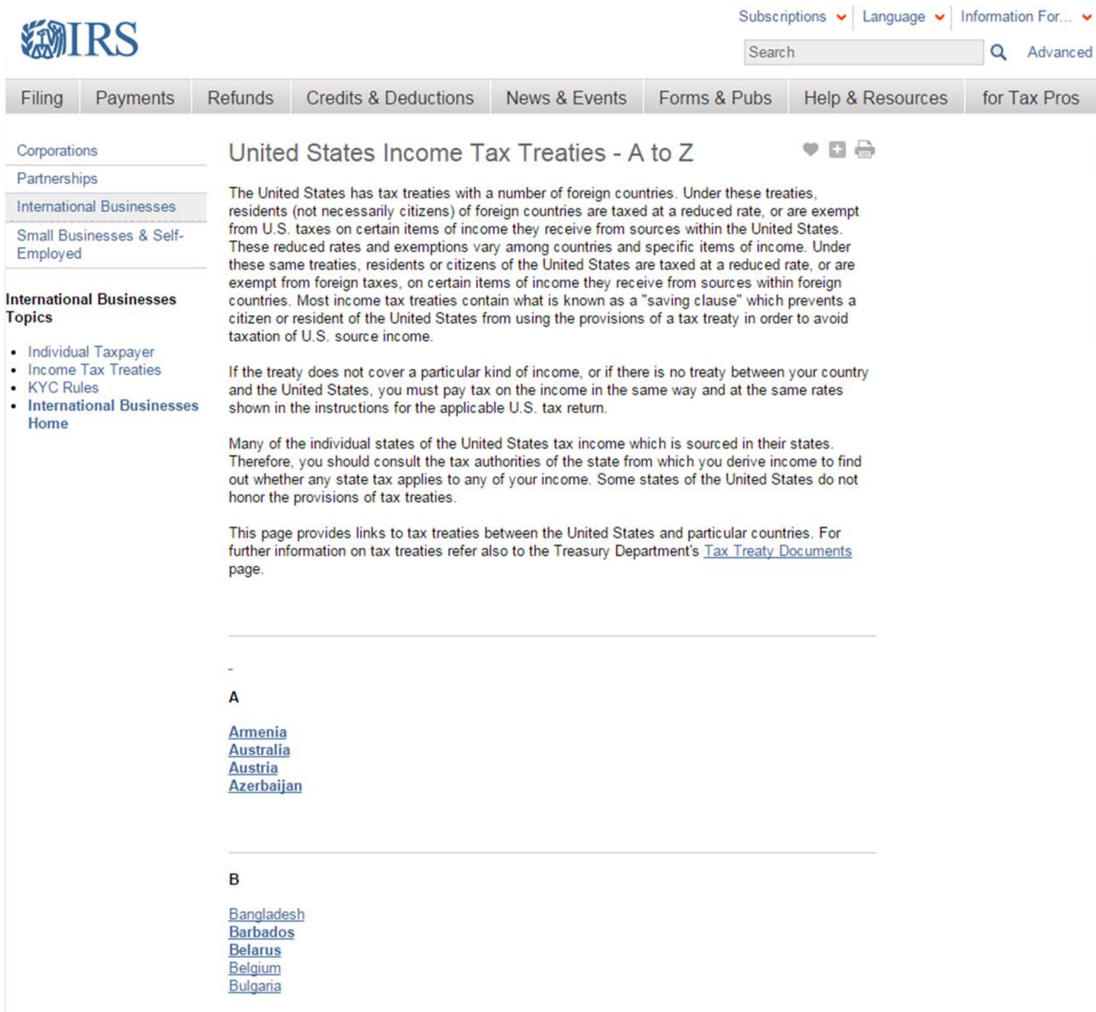
Form 708

* 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% x $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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Corporations
Partnerships
International Businesses
Small Businesses & Self-Employed

International Businesses Topics

- Individual Taxpayer
- Income Tax Treaties
- KYC Rules
- **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

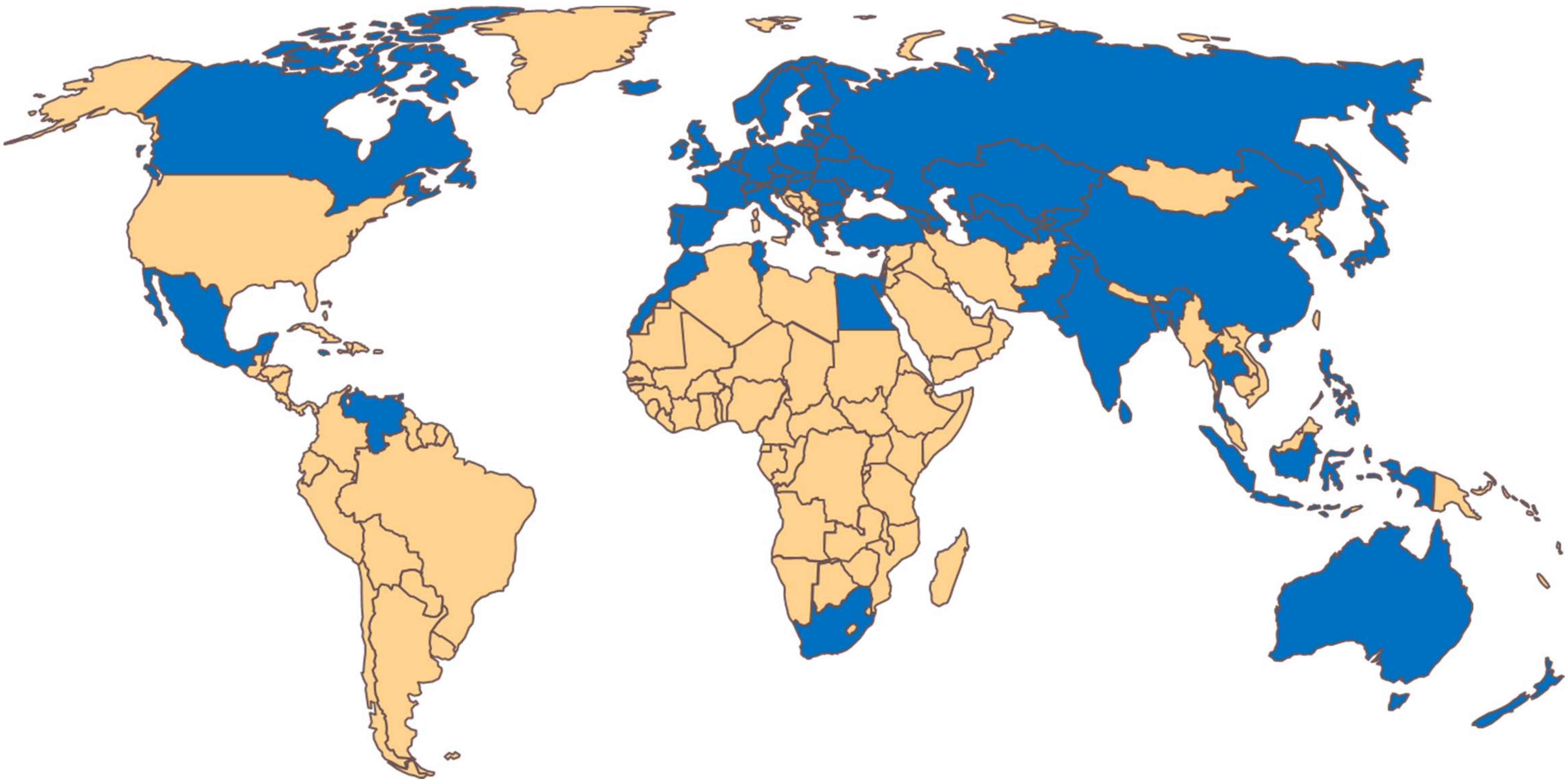
Armenia
Australia
Austria
Azerbaijan

B

Bangladesh
Barbados
Belarus
Belgium
Bulgaria

Available at http://ow.ly/TGSdp

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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TAX PROVISIONS IN ACQUISITION AGREEMENTS

By

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I. INTRODUCTION

In merger and acquisition transactions, the least fun part of the tax advisor's job is usually drafting the acquisition agreement, as compared to structuring the transaction. However, drafting the acquisition agreement is just as important as structuring the transaction to ensure that the allocation of tax liabilities and intended tax treatment to the parties are adequately addressed. Because tax issues can be lurking throughout an acquisition agreement, tax advisors are generally required to review and comment on the *entire* agreement. At bottom, there is no such thing as a "tax section" in an acquisition agreement.

Rather than focusing on form provisions for the so-called "tax provisions" of acquisition agreements (e.g., tax representations, tax covenants, etc.) that have been addressed in other speeches, articles, and treatises, this article focuses on the purpose of the "tax provisions" and on the numerous other places that tax issues may arise outside the "tax provisions." This is done by walking through a hypothetical acquisition agreement using the table of contents as a guide.

II. KEY QUESTIONS BEFORE REVIEWING AND COMMENTING ON THE ACQUISITION AGREEMENT

Before a tax advisor can begin commenting on an acquisition agreement, there are important questions that need to be asked first, including:

1. Is the client the buyer or seller?

Buyers and sellers have different objects when it comes to the acquisition agreement, including the following:

Buyer's Objectives	Seller's Objectives
Obtain information about target's tax history (i.e., through tax representations)	Minimize risk that transaction will not close
Limit restrictions on post-closing actions, including restructuring	Limit post-closing actions that could increase pre-closing tax liability
Indemnification for pre-closing taxes and tax attributes	Limit indemnity for pre-closing taxes

2. Who has the leverage?

In an auction process, for example, the bids may be very competitive so the markup of the bid form may influence whether a particular bidder is selected. As a result, the tax advisor may need to work with the seller's proposed language, rather than inserting the tax advisor's preferred form provisions.

3. Is the seller public, financial, or private?

As discussed below, the type of seller could impact the length of time for the survival of representations and whether there is an indemnity for pre-closing taxes. For example, if the target is a publicly traded corporation, there is no one to stand behind an indemnity after closing, so representations generally terminate at closing and there is no remedy post-closing in the event there was a breach of the tax representations.

4. Is there a letter of intent?

If the buyer and seller have entered into a letter of intent before involving the tax advisor, the tax advisor needs to know whether certain issues have already been "traded." For example, the letter of intent may address the structure of the transaction (e.g., asset sale v. stock sale, IRC § 338(h)(10) election). Additionally, the parties may have already negotiated the survival period for representations and limitations on the indemnity for taxes. Preferably, the tax advisors are involved at the beginning of the process.

5. How was the purchase price determined and how did tax affect that determination?

For example, if the buyer modeled its purchase price assuming a stepped-up tax basis in the assets of the target, then the tax advisor needs to draft the provisions to ensure that the buyer will obtain that step-up. For example, if the target is an S corporation and an IRC § 338(h)(10) election is contemplated, then the tax advisor needs to ensure that adequate provisions are included that contemplate obtaining the consents for that election and ensuring that the target qualifies as a S corporation, and if not, that there is an adequate indemnification.

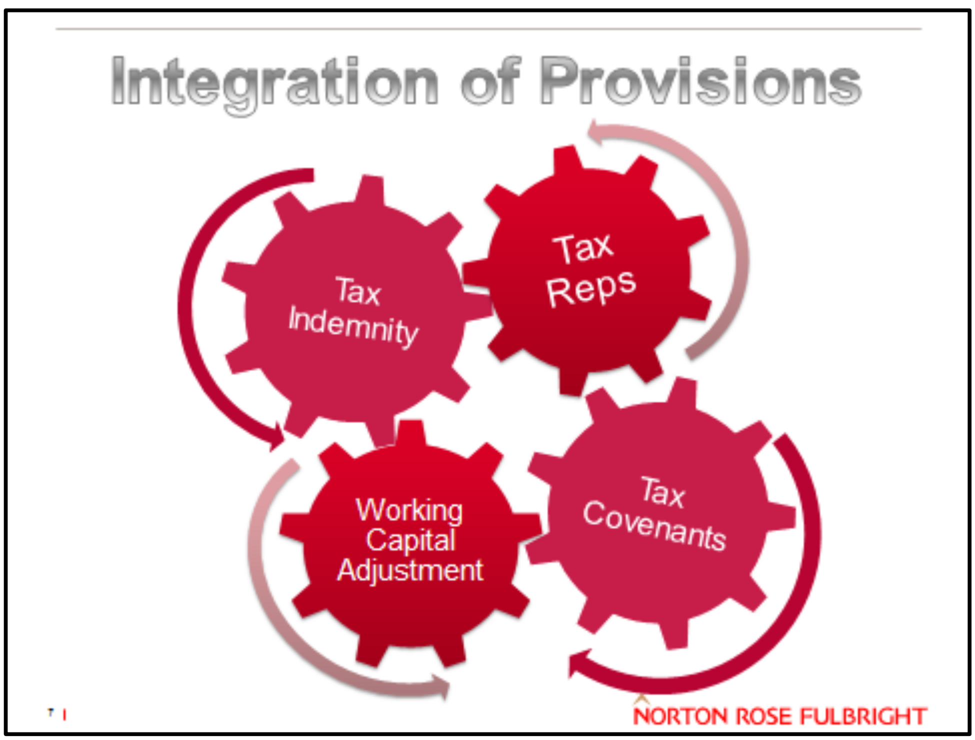
6. Does the seller expect deferral if he or she is receiving equity of the buyer?

If part of the purchase price to be received is stock or partnership interest of the buyer, then the tax advisor needs to ensure that the provisions will provide the seller with the expected tax deferral.

7. Has the structure been agreed on?

Certain tax risks may be allocated between the parties depending on the structure of the transaction. For example, if a buyer's purchase price was determined assuming a stepped-up basis and the target is an S corporation, then a stock purchase with an IRC § 338(h)(10) election may need to be restructured as an asset purchase so that the buyer does not take the risk that there is no step-up in the event the target's S election is not valid. Instead, that risk is transferred to the buyer who will incur corporate level tax in the event the S election is not valid.

III. INTEGRATION OF PROVISIONS



While reviewing and commenting on the acquisition agreement, the tax advisor needs to keep in mind that all the provisions need to work together to obtain the client's objectives. For example, if the seller has made a representation that the target has paid all of its taxes, then the buyer will want to make sure that a breach of that representation is adequately covered in the tax indemnity provision. Similarly, if that unpaid tax has been taken into account in the working capital adjustment as discussed below or otherwise through a reduction in the purchase price, then the seller will want to make sure that the tax indemnity is reduced by such amount or else the seller will effectively bear the economic burden of that tax twice.

IV. REVIEW AND COMMENT

To discuss the tax issues that may arise through an acquisition agreement, various issues are raised and discussed by using a hypothetical table of contents as a guide. Just as every deal is different, so too is every acquisition agreement. Accordingly, the various tax issues addressed below may not be present in an acquisition agreement and others not addressed here may be present. So it is worth repeating that there is no such thing as a "tax section," and the tax advisor needs to review and analyze the *entire* acquisition agreement.

A. Definitions

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In the hypothetical acquisition agreement used here, the definition section is in the beginning, but in many cases the definition section will be in the back of the agreement or attached as an exhibit. Regardless of its location, the definition section will have many important terms that will impact the operative provisions of the acquisition agreement, including the tax representations, tax covenants, and tax indemnity. As the operative provisions are reviewed, the definitions will likely need to be reviewed several times to make sure the applicable definition works with the concepts being addressed in the particular section of the acquisition agreement being reviewed.

For example, there will likely be a definition of "Taxes" that could be broadly defined by a buyer as:

> "***Tax***" or "***Taxes***" means, however denominated, (a) any and all taxes, assessments, customs, duties, levies, fees, tariffs, imposts, unclaimed property and escheat obligations, deficiencies and other governmental charges of any kind whatsoever imposed by any Governmental Body (including, but not limited to, taxes on or with respect to net or gross income, franchise taxes, profits taxes, gross receipts taxes, capital taxes, sales taxes, use taxes, ad valorem taxes, value added taxes, transfer taxes, real property transfer taxes, transfer gains taxes, inventory taxes, escheat and unclaimed property obligations, capital stock tax, license fees, payroll taxes, employment taxes, social security taxes, unemployment taxes, severance taxes, occupation taxes, real or personal property taxes, estimated taxes, rent taxes, excise taxes, occupancy taxes, recordation fees, bulk transfer obligations, intangibles taxes, alternative minimum taxes, doing business taxes, withholding taxes and stamp taxes), together with any interest thereon, penalties, fines, damages, costs, fees, additions to tax or additional amounts with respect thereto, whether disputed or not; or

(b) any liability for the payment of any amounts of the type described in clause (a) as a result of the operation of Law or any express or implied obligation to indemnify any other Person.

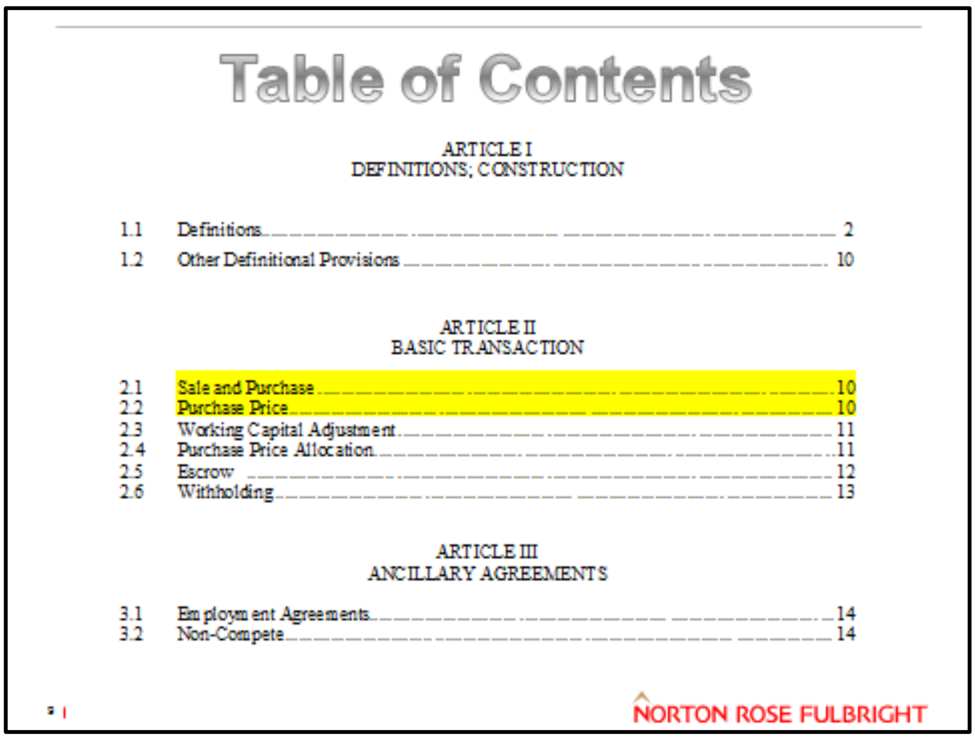
Alternatively, the definition of "Taxes" could be defined narrowly by the seller as follows:

> "***Tax***" or "***Taxes***" means all federal, state, local, and foreign income, profits, franchise, sales, use, ad valorem, property, severance, production, excise, stamp, real property transfer or gain, gross receipts, goods and services, registration, capital, transfer, or withholding taxes imposed by any Governmental Body.

Like all the provisions in the acquisition agreement, whether a provision is right or wrong depends on whether it captures the agreement and understanding of the parties. For example, the first definition of "Taxes" specifically includes escheat obligations, whereas the second does not. The goal is to meet the objectives of the relevant party being represented. If that party intends for escheat obligations to be covered by a pre-closing tax indemnity that incorporates the definition of "Tax," then the first definition works and the second does not. Conversely, the first definition may be overly broad for the seller since it includes "other governmental charges of any kind whatsoever." The seller may want to modify that phrase to be in the "nature of a tax" or some other qualifier that does not pick up all possible charges (e.g., government fines).

Other common tax-related definitions that need to be reviewed include definitions for "Straddle Period," "Pre-Closing Tax Period," "Tax Authority," "Tax Return," etc.

B. Sale and Purchase & Purchase Price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DEFINITIONS; CONSTRUCTION

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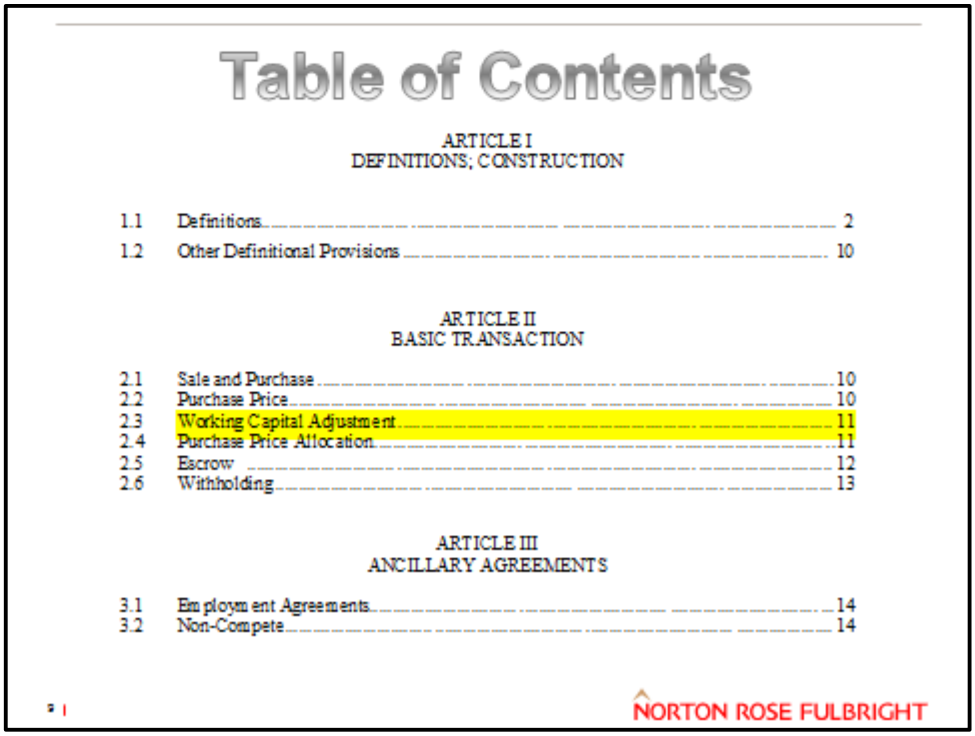
The next two items in the hypothetical acquisition agreement that raise tax issues are the "Sale and Purchase" provision and the "Purchase Price" provision. If the tax advisor did not know the proposed structure for the transaction, the "Sale and Purchase" provision generally sets forth the structure of the transaction (e.g., asset sale, stock sale, merger, etc.). If the buyer is expecting a stepped-up basis in the assets of the target, then the tax advisor will know from this provision whether certain elections will need to be made, such as an IRC § 754 election[1]

[1] A purchaser of a partnership interest holding appreciated assets should either assure himself that an IRC § 754 election is in effect or obtain contractual assurances that one will be made. An IRC § 754 election triggers an IRC § 743 adjustment which increases the adjusted basis of partnership property to the extent the purchasing partner's basis in his partnership interest is greater than his proportionate share of the adjusted basis of all partnership assets or decreases it to the extent the incoming partner's basis in the partnership interest is less than his proportionate share of the adjusted basis of all partnership assets.

in the event the target is a partnership or an IRC § 338(h)(10) election[2] in the event the target is an S corporation or member of an affiliated group. The "Purchase Price" provision will generally set forth the consideration to be received by the seller. If the seller is receiving consideration other than cash, then the tax advisor will know that consideration will need to be given as to whether the non-cash purchase price, such as stock or partnership interest, can be received without the current recognition of gain.

C. Working Capital Adjustment



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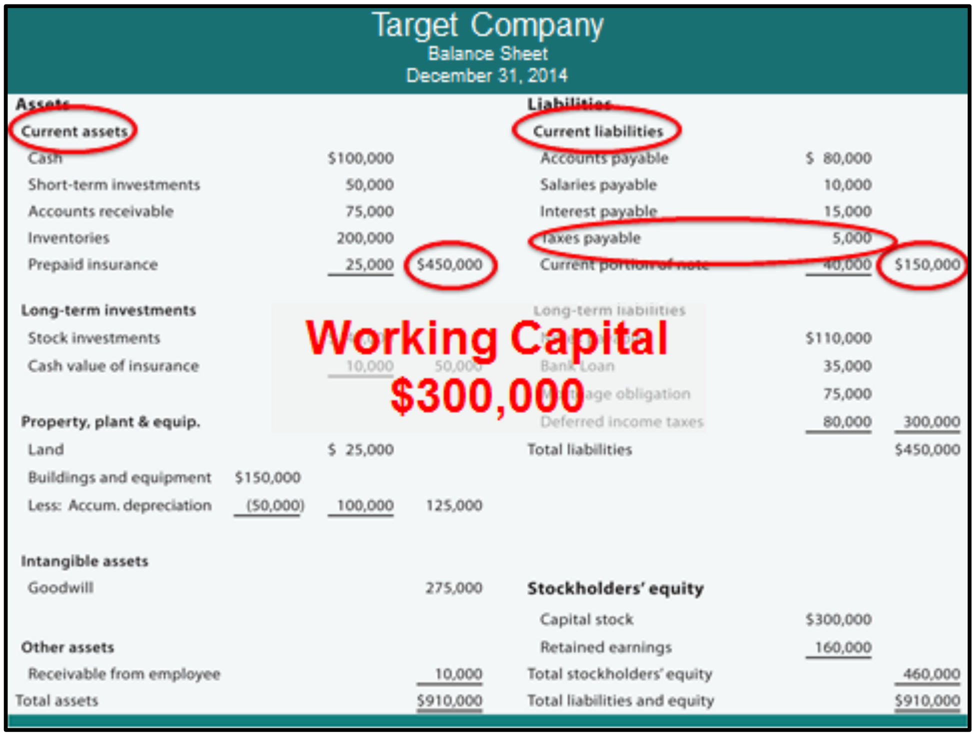
The next item in the hypothetical acquisition agreement that raises tax issues is the "Working Capital Adjustment" provision. The working capital adjustment adjusts the purchase price to take into account the difference between the working capital reflected on the balance sheet used to determine the purchase price and the working capital reflected on the closing date balance sheet. Working capital is generally defined as current assets less current liabilities. In general, current assets (e.g., accounts receivables) and current liabilities (e.g., accounts payable) generate or use cash, respectively, within a 12-month period and are usually determined based on GAAP. However, deferred taxes and deferred tax assets are generally excluded from the definitions of current liabilities and current assets, respectively, because they reflect timing differences between GAAP and tax (i.e., not cash items). Buyers generally want to make sure that current taxes are included so that the purchase price is reduced by these taxes and avoids the buyer having to seek indemnification from the seller later. Conversely, the seller generally wants to exclude current taxes from the calculation so that its purchase price is not reduced and the buyer is required to seek indemnification later, which gives the seller the time value benefit of holding on to the cash and may result in a permanent benefit if the buyer fails to or decides not to pursue the indemnification. On the other hand, the buyer generally wants to exclude refunds from the calculation to avoid having to increase the purchase price currently and risk not receiving the refund, and the seller generally wants to include the refund to receive the cash currently, rather than when the refund is later received and then paid over by the buyer.

The balance sheet below illustrates a working capital adjustment:

[2] When both parties jointly make an IRC § 338(h)(10) election, the transaction is treated as if the target sold its assets to a new corporation for cash and then liquidated, distributing the cash to the shareholders. The election allows a buyer to purchase the stock of a target but have the transaction characterized as an asset sale for tax purposes and receive a step up in basis equal to the fair market value of the assets.



Target Company
Balance Sheet
December 31, 2014

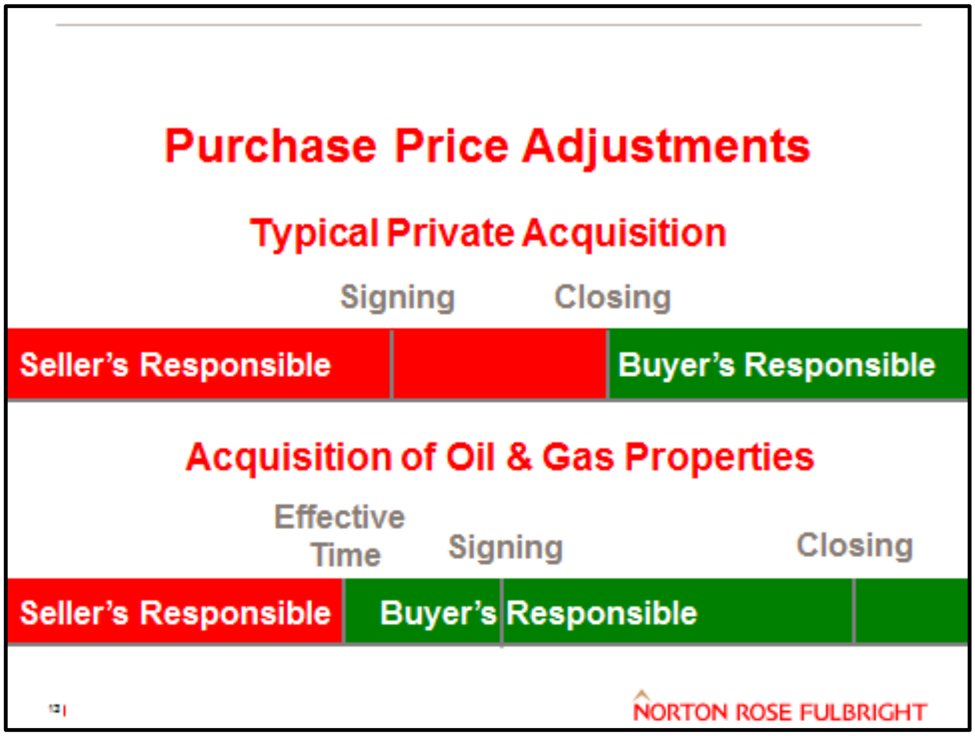
Assets				Liabilities		
Current assets				Current liabilities		
Cash		$100,000		Accounts payable	$ 80,000	
Short-term investments		50,000		Salaries payable	10,000	
Accounts receivable		75,000		Interest payable	15,000	
Inventories		200,000		Taxes payable	5,000	
Prepaid insurance		25,000	$450,000	Current portion of note	40,000	$150,000
Long-term investments				Long-term liabilities		
Stock investments		[illegible]		[illegible]	$110,000	
Cash value of insurance		10,000	50,000	Bank Loan	35,000	
				Mortgage obligation	75,000	
Property, plant & equip.				Deferred income taxes	80,000	300,000
Land		$ 25,000		Total liabilities		$450,000
Buildings and equipment	$150,000					
Less: Accum. depreciation	(50,000)	100,000	125,000			
Intangible assets						
Goodwill			275,000	Stockholders' equity		
				Capital stock	$300,000	
Other assets				Retained earnings	160,000	
Receivable from employee			10,000	Total stockholders' equity		460,000
Total assets			$910,000	Total liabilities and equity		$910,000

Here, Target's working capital is $300,000 because its current assets of $450,000 exceed its current liabilities of $150,000. If this were the closing date balance sheet and the working capital on the balance sheet used to determine the purchase price was $200,000 (often referred to as the working capital "peg"), the working capital adjustment (i.e., increase in purchase price) would be $100,000. In this example, the taxes payable of $5,000 are taken into account as an adjustment to the purchase price. As a result, if there is a pre-closing tax indemnity as discussed below, the seller will want to make sure that such indemnity is reduced by the amount of accrued taxes that have been taken into account in determining the working capital adjustment.

If there is no working capital adjustment contemplated in the purchase agreement, the tax advisor for the buyer may want to insert a provision in the determination of the purchase price provision that the purchase price will be reduced by certain estimated taxes, such as the seller's share of prorated property taxes. If not, the buyer will be required to seek an indemnification from the seller after the closing for a liability that can be reasonably estimated prior to closing. If there is a reduction for estimated taxes, then the tax covenants will generally require a "true-up" when the actual tax liability is known. This is an example of how the tax advisor needs to ensure that the tax-related provisions in the acquisition agreement work together.

In the case of oil and gas properties, the seller (rather than the buyer) is generally the party that wants to adjust the purchase price for certain pre-closing taxes. This is because oil and gas transactions are generally priced based on a reserve report that pre-dates the closing.

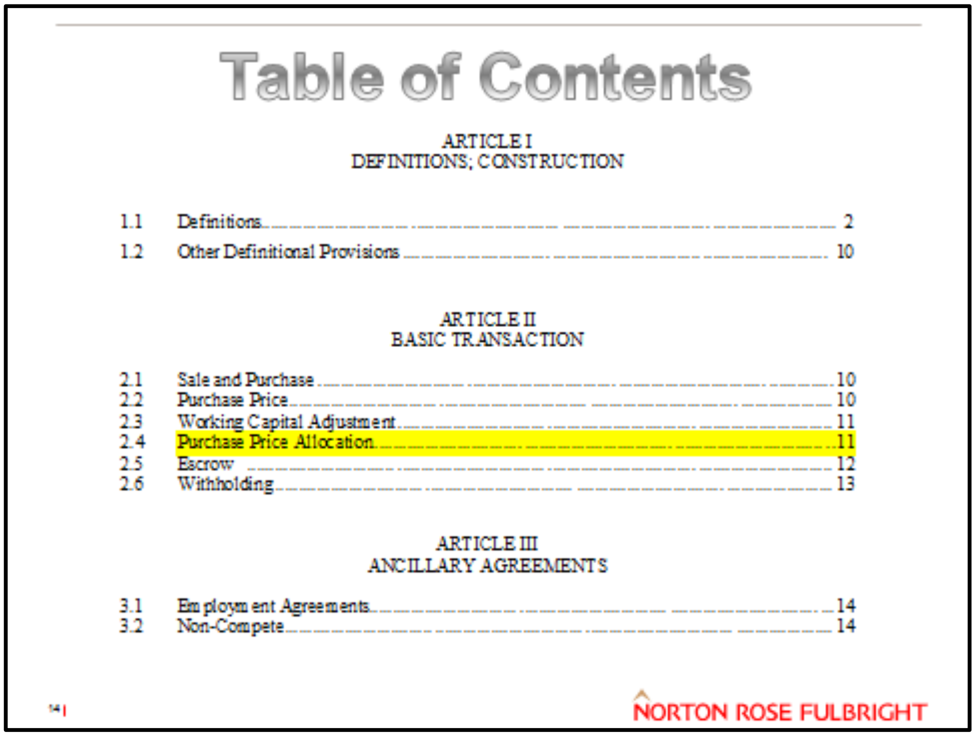
The below illustration demonstrates the differences between the responsibility for taxes prior to the closing:



The reason for the difference in an oil and gas transaction is that the property is a depleting asset, so the seller’s purchase price is reduced by the production of hydrocarbons between the “effective time” and closing. However, since the seller’s purchase price is reduced to economically put the buyer in the same place as it would have been had the transaction closed at the “effective time,” the seller’s purchase price is increased to account for expenses it incurred in producing the hydrocarbons, including severance, ad valorem, property, and production taxes.[3] To be clear, the buyer and seller are not backing dating documents or taking the position that the transaction closed before it actually did; instead, they are just putting the buyer and seller in the economic positon each would have been in if the transaction had closed at the effective time.

[3] Although the buyer generally bears the economic costs for certain taxes (e.g., severance taxes) between the effective time and closing, the seller should be responsible for any interest or penalty charged as a result of the seller failing to timely pay these taxes since the seller was in control of the payments during this period.

D. Purchase Price Allocation



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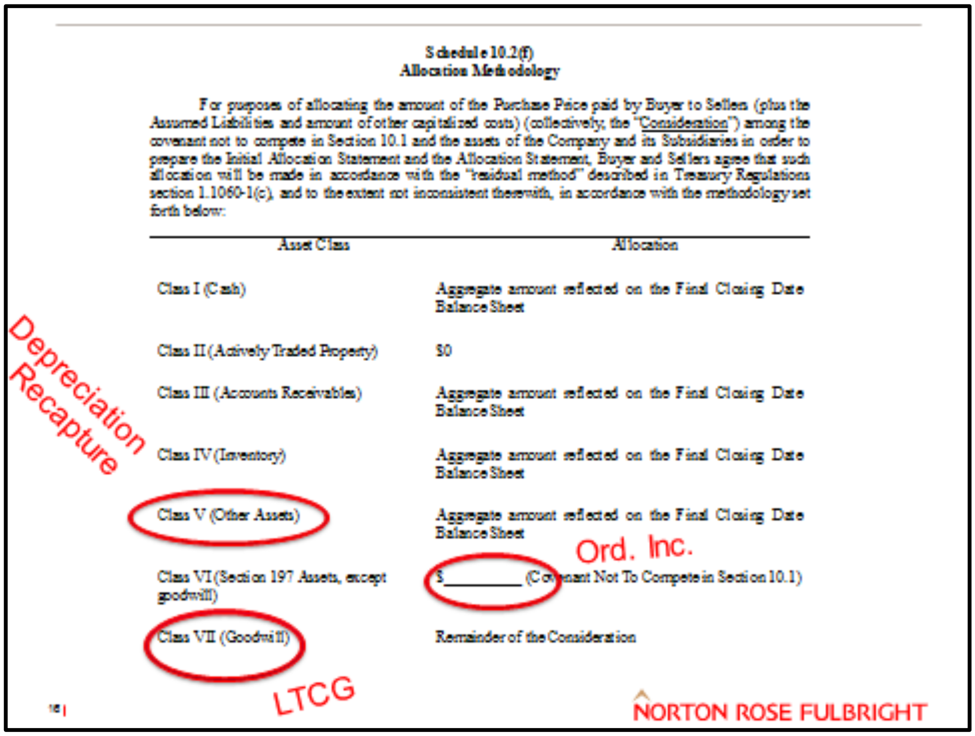
The next item in the hypothetical acquisition agreement that raises a tax issue is the "Purchase Price Allocation" provision. The purchase price allocation section generally sets forth the parties' agreement as to how the purchase price (plus other capitalized costs, including the assumption of liabilities) will be allocated among the assets in certain types of acquisitions, such as the purchase of a disregarded entity, asset purchase, purchase of a partnership interest, or a stock purchase where an IRC § 338(h)(10) election will be made. The buyer and seller will often have adverse interests in determining such allocation.[4] For example, an individual seller will generally want as much of the purchase price being allocated to assets that will result in long-term capital gain, such as goodwill,[5] rather than assets that generate ordinary income, such as depreciable property that is subject to depreciation recapture.[6] Conversely, a buyer generally wants to allocate the purchase price to assets that will generate tax benefits on an accelerated basis, such as short-lived depreciable assets.[7] Although there is no requirement that buyers and sellers actually agree on the allocation of the purchase price, the thought is that a party's allocation is less likely to be challenged if the other party who bargained at arm's length is reporting the transaction consistently.

In many cases, the final purchase price cannot be determined prior to closing (e.g., if there is a working capital adjustment determined post-closing), and therefore, the purchase price allocation may not be able to be agreed upon prior to closing. In such case, the parties will have to determine how the purchase price will be allocated post-closing. That could be pursuant to a post-closing valuation or agreed upon methodology. In the case of an individual seller where tax rates may be different depending on the amount allocated to items that generate capital gain versus ordinary income, such a seller may not be willing to allow a third-party appraiser to determine the seller's after-tax cash. In such case, the individual seller may want to have an agreed upon methodology that ensures the ordinary income items will be limited to certain amounts. An example of such a methodology is below:

[4] In each of these cases, the buyer is treated as purchasing assets even if it is actually purchasing the equity interest in a legal entity. *See supra* notes 1- 2 and accompanying text.
[5] IRC §§ 197, 1231.
[6] IRC § 1245.
[7] For example, a buyer will advocate for allocations to inventory or other assets with three-year or five-year depreciable lives. *See* IRC § 168(c).



Schedule 10.2(f)
Allocation Methodology

For purposes of allocating the amount of the Purchase Price paid by Buyer to Sellers (plus the Assumed Liabilities and amount of other capitalized costs) (collectively, the "Consideration") among the covenant not to compete in Section 10.1 and the assets of the Company and its Subsidiaries in order to prepare the Initial Allocation Statement and the Allocation Statement, Buyer and Sellers agree that such allocation will be made in accordance with the "residual method" described in Treasury Regulations section 1.1060-1(c), and to the extent not inconsistent therewith, in accordance with the methodology set forth below:

Asset Class	Allocation
Class I (Cash)	Aggregate amount reflected on the Final Closing Date Balance Sheet
Class II (Actively Traded Property)	$0
Class III (Accounts Receivables)	Aggregate amount reflected on the Final Closing Date Balance Sheet
Class IV (Inventory)	Aggregate amount reflected on the Final Closing Date Balance Sheet
Class V (Other Assets)	Aggregate amount reflected on the Final Closing Date Balance Sheet
Class VI (Section 197 Assets, except goodwill)	$________ (Covenant Not To Compete in Section 10.1)
Class VII (Goodwill)	Remainder of the Consideration

The above allocations schedule follows the asset classes set forth in the Treasury regulations under IRC § 1060. The first four classes are generally taken into account in the working capital adjustment, which is generally determined based on the "Final Closing Date Balance Sheet." As a result, the amount reflected on the Final Closing Date Balance Sheet is the price actually paid for those assets. The other classes are where the negotiation takes place. The Class V assets include the property, plant, and equipment. Since these items generally would have been depreciated, the seller's incentive is to allocate as little as possible to these items to avoid depreciation recapture, which is subject to ordinary tax rates.[8] The buyer, on the other hand, is incentivized to allocate more to these items to increase its post-closing depreciable tax basis. Since the amount allocated to a noncompete generates ordinary income,[9] sellers generally want as little as possible allocated to them. Although covenants not to compete and goodwill are generally amortized over a 15-year period,[10] a buyer nevertheless wants some reasonable allocation to the covenant not to compete in the event the buyer is required to seek judicial enforcement of the covenant.

In the event there is a dispute as to the post-closing allocation, the purchase price allocation may (and should) contemplate a dispute resolution mechanism. In many cases there will be a dispute resolution mechanism for other purposes that the purchase price allocation provision will incorporate.

Finally, the purchase price allocation provision will generally include a provision that the parties will report the transaction for applicable tax purposes in a manner consistent with the agreed purchase price allocation and not take any position in a tax controversy that is inconsistent with such allocation without the prior consent of the other party. If such an agreement is made, the parties should consider whether there should be some limitation on the tax controversy provision to allow the parties to settle a tax controversy, regardless of whether the other party's consent is obtained.

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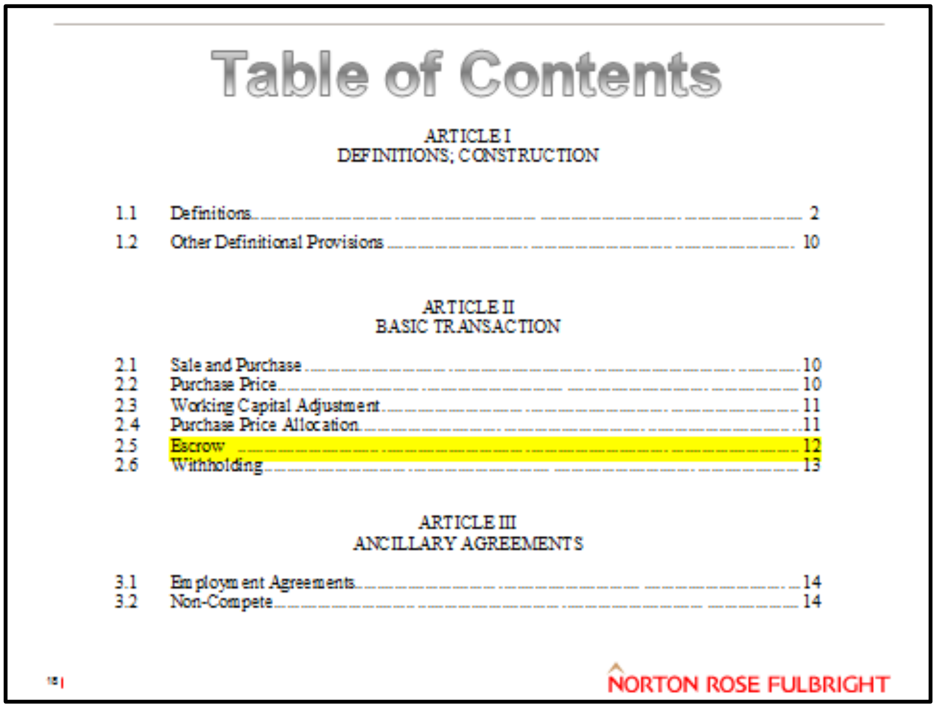
[8] IRC § 1245.
[9] IRC § 197; Rev. Rul. 69-643, 1969-2 C.B. 10.
[10] IRC § 197.

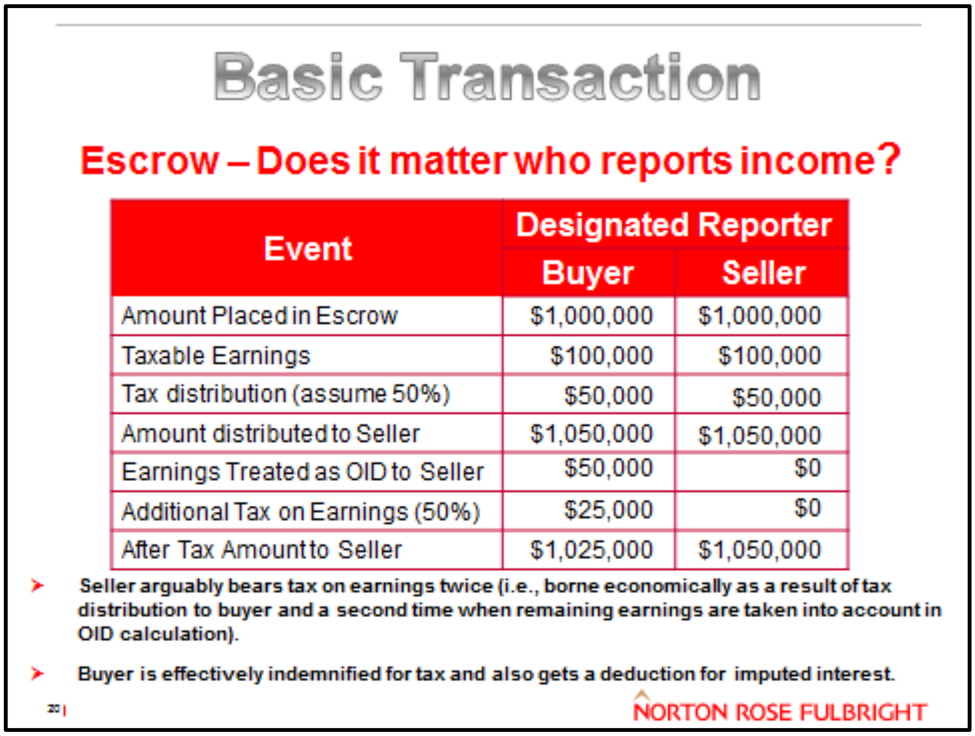
E. Escrow



The next item in the hypothetical acquisition agreement that raises a tax issue is the "Escrow" provision. A buyer may require that a portion of the purchase price be placed in an escrow that can be used by the buyer to satisfy its indemnification claims and other items. The terms of the escrow are generally set forth in a separate escrow agreement that is attached as an exhibit to the acquisition agreement. If the escrow is held for more than 1 year, then a portion of the escrow will be treated as interest under the original issue discount rules ("OID"), resulting in an interest deduction for the buyer and interest income to the seller.[11] The amount placed in escrow may also generate taxable income during the period the funds are held by the escrow agent (e.g., placed in interest bearing account or other investments). For federal income tax purposes, the parties can generally designate the party that will report the income during this period.[12] In the event a party is designated as the party that will report the taxable income during the period funds are held in escrow, that party may require that a portion of the funds be paid to that party so that it can pay the resulting tax. In many cases, the parties will agree on an assumed tax rate (e.g., 50%). The parties may also agree as to whether payments will be made quarterly, to account for estimated tax payments, or one annual payment. One of the tax issues to be considered by the seller is whether it matters if the seller or the buyer is designated as the party that reports the taxable income. As demonstrated below, the seller could economically bear tax twice on the same amount if the buyer is designated as the reporting party.

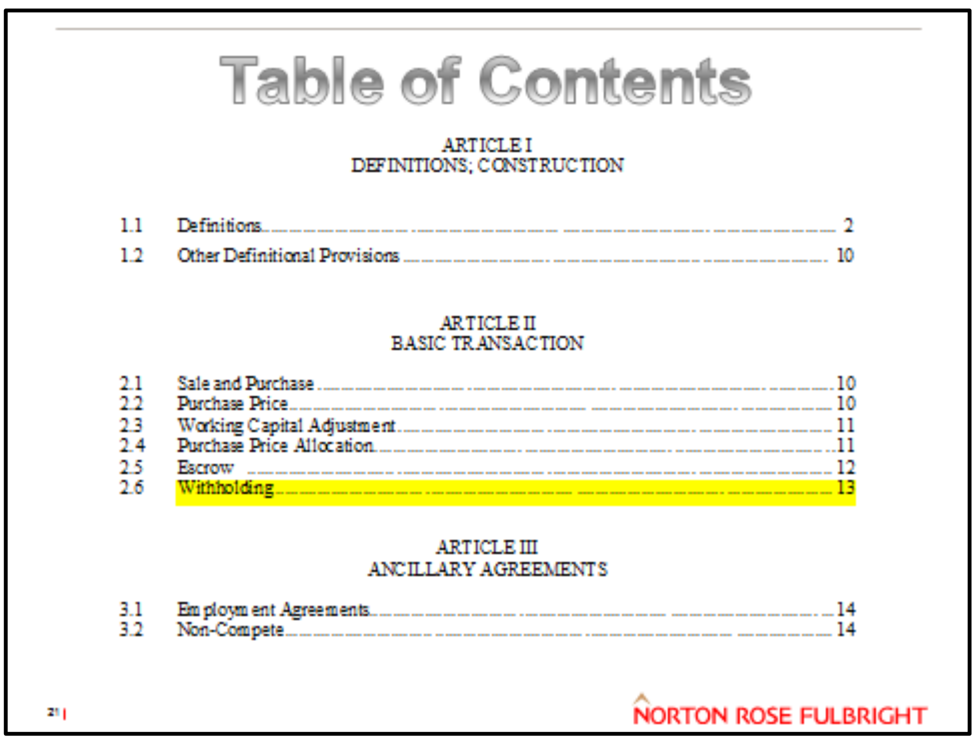
[11] IRC §§ 1271-1274.

[12] Until Prop. Treas. Reg. § 1.468B-8 is finalized, the Internal Revenue Service will respect reasonable, consistently applied methods of reporting and taxing income earning by the escrow.



As the calculations above shows, there is no additional OID taken into account as a result of the earnings if the seller reports the income because the seller has already paid tax on such amount. However, when the buyer reports the income, the remainder of the earnings is taken into account under the OID rules even though the seller has economically borne the tax as a result of the distribution to the buyer to pay the tax on such earnings. In low interest rate environments, this may not be a material issue. Additionally, if there are multiple sellers, the administrative burden of allocating the taxable income among the various sellers may outweigh the additional tax costs by designating the buyer as the reporting person.

F. Withholding

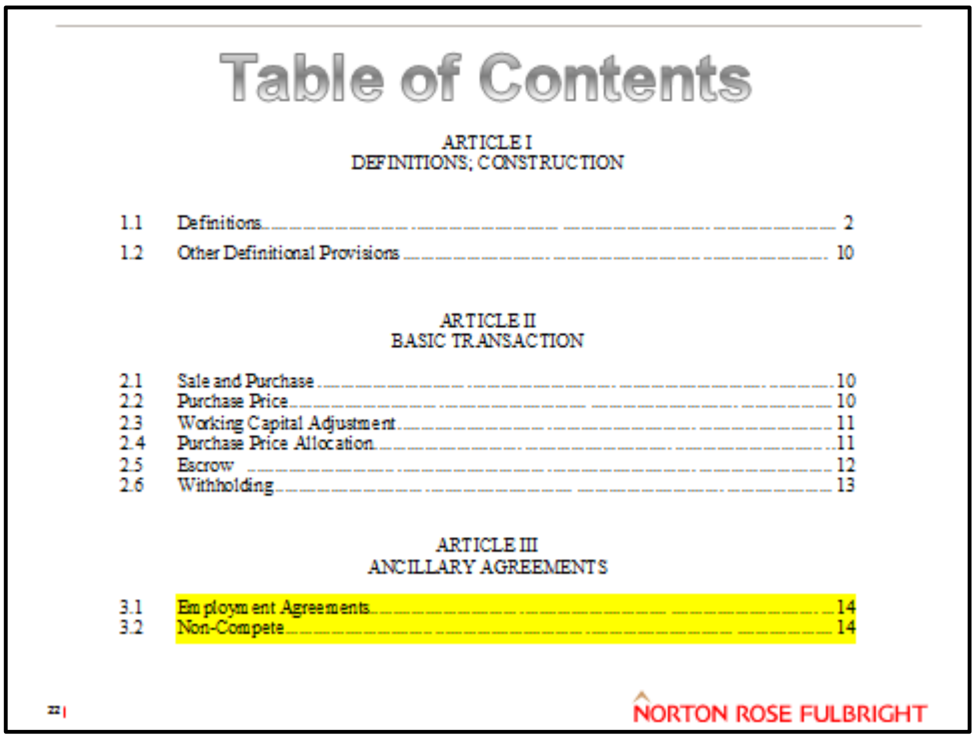


The next item in the hypothetical acquisition agreement that raises a tax issue is the "Withholding" provision. In many acquisition agreements, the buyer will include a provision authorizing it to withhold applicable taxes. An example of such provision is as follows:

> Section 2.6 Withholding. Notwithstanding any other provision in this Agreement, the Buyer shall be entitled to deduct and withhold from the payments to be made pursuant to this Agreement and any related agreements any Taxes required to be deducted and withheld with respect to the making of such payments under the Code, the Treasury Regulations issued thereunder, or any other provision of any applicable Legal Requirement. To the extent that amounts are so withheld and deducted pursuant to this Section 2.6, such withheld amounts shall be treated for all purposes of this Agreement as having been paid to Seller in respect of which such deduction and withholding was made.

Sellers generally want to know the amount of cash that will be received at closing and whether the buyer has any reason to believe withholding will be required. As a result, sellers will often object to the insertion of the provision unless the buyer can articulate a valid reason. In many cases, the buyer may not be aware of any withholding obligation at the time of signing the acquisition agreement, but wants the provision to avoid a dispute later in the event a withholding obligation is determined after signing but before a payment is made. If a seller is providing a FIRPTA certificate,[13] a seller may want to specifically provide that no withholding will be made under FIRPTA.

G. Ancillary Agreements



The next items in the hypothetical acquisition agreement that raise tax issues are in the "Ancillary Agreements" provision. An acquisition agreement will generally include additional agreements, often attached as exhibits, that will be executed at the closing of the transaction. These ancillary agreements typically include employment agreements, noncompete agreements, and restructuring agreements, all of which raise tax issues.

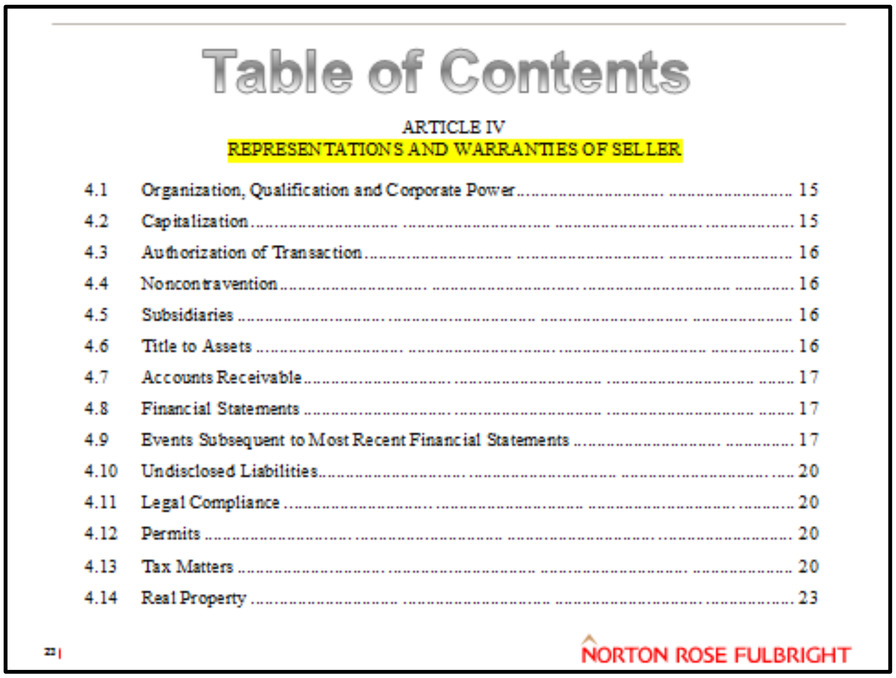
[13] A buyer will generally require that at closing it receive a certificate that the seller is not a foreign person or that the target is not a U.S. real property holding corporation under IRC § 897(c)(2), to ensure that the buyer is not required to withhold any amounts from the purchase price under IRC § 1445.

Employment agreements could include equity grants in the buyer that are subject to vesting. In such case, the tax advisor will need to review the employment to determine whether the seller should be advised to make an IRC § 83(b) election.[14]

As discussed above with respect to the purchase price allocation provision, the amount of the purchase price allocated to a covenant not to compete of an individual results in ordinary income, rather than long-term capital gain. As a result, the tax advisor will need to determine whether the covenant not to compete contains any language that is inconsistent with an agreed allocation to such covenant.

An acquisition agreement may also contemplate a restructuring of the target before closing or certain transactions required to take place prior to the closing. In such cases, those transactions may be set forth in the ancillary agreement section because the buyer and seller both have an interest in how that restructuring of those transactions are effected. For example, if a seller is required to convert the target entity from a corporation to an LLC prior to closing so that the buyer is treated as buying assets, rather than stock, for federal income tax purposes, the buyer will want to make sure that conversion has occurred and that the LLC will be treated as a disregarded entity at the time of closing.

H. Representations and Warranties



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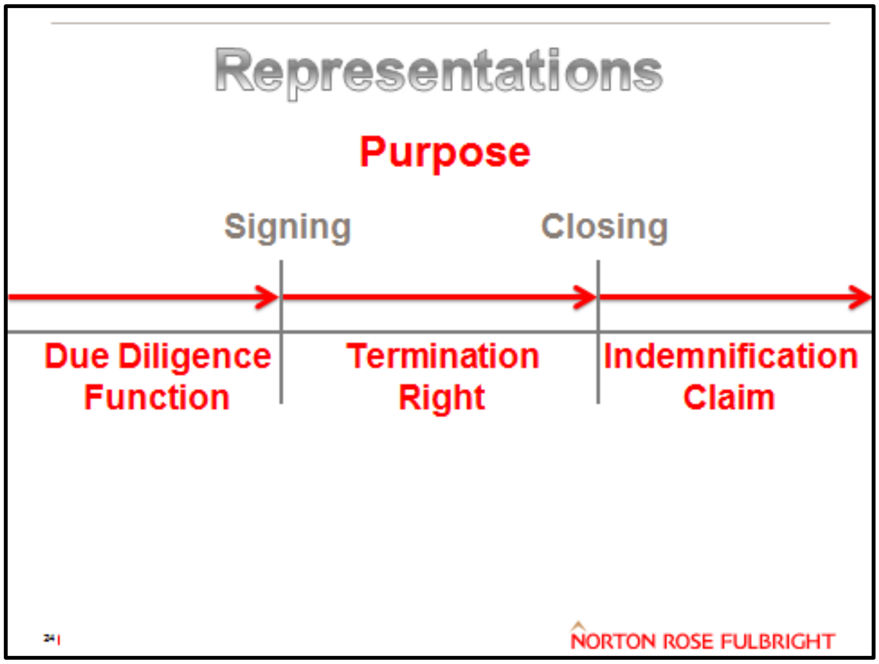
ARTICLE IV
REPRESENTATIONS AND WARRANTIES OF SELLER

The next item in the hypothetical acquisition agreement that raises tax issues is the "Representations and Warranty" provision. With respect to tax and other issues, the representations and warranty provision has several purposes depending on the applicable point in time of the acquisition as reflected in the following chart:

[14] A seller that makes an IRC § 83(b) election within 30 days of the receipt of restricted property subject to a substantial risk of forfeiture currently recognizes the excess of the fair market value over any amount paid for the property. Any later appreciation in value of the property will enjoy capital gain treatment.



Before signing the acquisition agreement, the representations are a due diligence tool that can be used to find out information about the target. For example, a buyer will typically ask for a representation that the target is not currently under audit and that there is no pending controversy with a taxing authority. This is one way to find out from the seller whether there are potential tax issues that need to be analyzed further to determine the extent of any exposure. After signing, a breach of the representation that is discovered before closing may provide a termination right for the buyer. In general, representations are "brought down" (i.e., affirmed) at closing, and if breaches of those representations exceed a specified threshold (e.g., all representations are accurate in all "material" respects), then the buyer can terminate the transaction. After the closing, the representations can provide the basis of an indemnity claim as discussed below.

Representations are generally drafted by the buyer very broadly because of the three purposes discussed above. Sellers will then generally negotiate to narrow the breadth of the representation to make them "relevant" to the deal. Sellers can also generally provide a schedule of items that are exceptions to the representations. For example, if there a representation that there are no pending tax audits, the seller can list on a schedule applicable to that representation a tax controversy that is pending to avoid a breach of that representation. Schedules need to be reviewed by the tax advisors for the seller and the buyer carefully. A buyer must review the schedule because the disclosure of a breach generally eliminates a termination right with respect to that disclosed item and may eliminate an indemnification claim for a breach of the representation after closing if the indemnification provision takes into account the disclosed item for purposes of determining whether a breach has occurred or in the determination of the damages. Sellers also need to be careful in disclosing breaches of representations because the acquisition agreement is not privileged, so a taxing authority may request a copy of the acquisition agreement and discover a potential issue that is described in the schedule.

The non-tax representations should also be reviewed as a due diligence matter because those representations will generally provide information that could have a bearing on the tax representations to be obtained. The below chart indicates the section reference in the hypothetical acquisition agreement and the information that may be obtained that is relevant to tax:

4.1 Organization, Qualification	Indicates states and countries where target is qualified, which likely means that target is subject to tax in those jurisdictions.
4.2 Capitalization	Generally sets for the capital structure of the target, which may be relevant to determine whether there is a second class of stock issue if the target is an S corporation and whether there may be debt-equity issues.
4.5 Subsidiaries	If the target has subsidiaries, the tax representations (and other provisions) will need to cover those subsidiaries as well.
4.8 Financial Statements	Representations about the target's financial statements indicate that financials are available and the basis on which prepared (e.g., GAAP). Those financial statements should be reviewed because the tax reserves and footnotes can provide significant information.

Depending on the structure of the applicable acquisition and the acquisition agreement, there may be other non-tax representations that will provide helpful information.

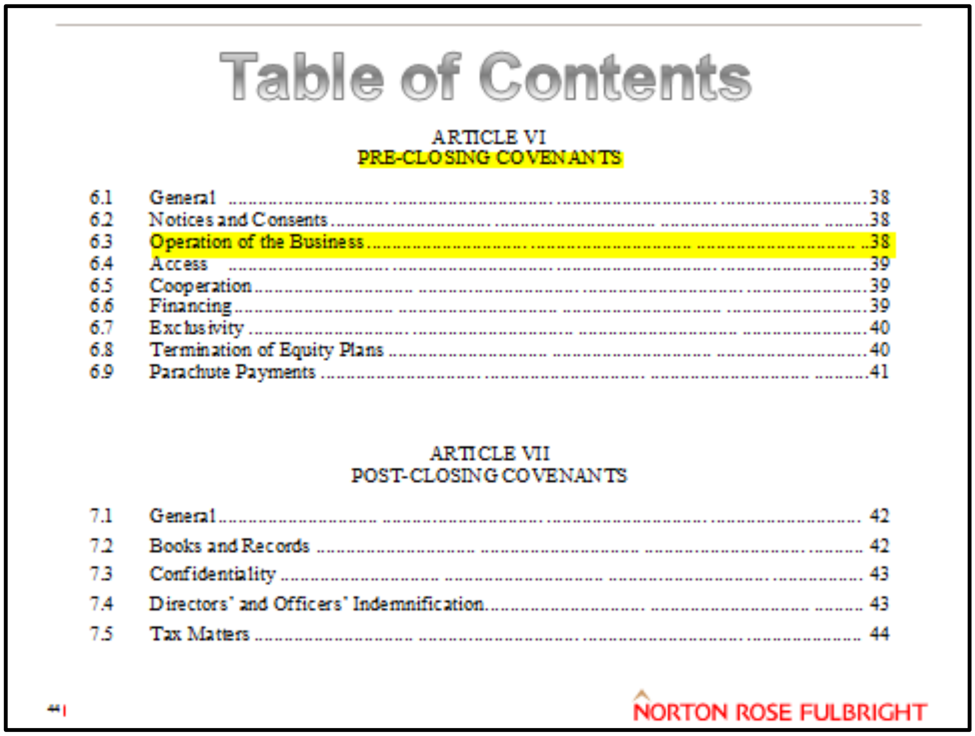
The scope of the tax representations will depend on a number of factors. To a large extent, the structure of the transaction will determine the scope of the tax representations. For example, a stock purchase agreement for the acquisition of a "C" corporation will be very different from an asset purchase agreement. In a stock purchase, the target's tax attributes (e.g., basis, E&P, etc.) will generally remain, and the target will continue to be liable post-closing for any unpaid taxes. In an asset purchase, the buyer has a stepped-up basis in the assets and is generally not liable for the prior taxes of the seller (assuming no successor or transferee liability). The type of assets will make a difference as well. For example, in an acquisition of oil and gas properties, the transaction may be an asset deal for all other purposes, but the assets may be subject to a tax partnership, which effectively results in the transaction being treated as a purchase of a partnership interest for federal income tax purposes.

In the event part of the purchase price includes equity of the buyer, the seller may seek representations with respect to the buyer. However, although a seller may attempt to make the tax representations of the buyer reciprocal, the scope of the representations may be significantly less, such as if the buyer is a publicly traded company.

Sellers often insert "material" or "knowledge" qualifiers to the tax representations so that there is no breach in the event the breach is not " material" or the seller did not have "knowledge" that the representation was breached. The impact of "material" and "knowledge" qualifiers on the three purposes of representations is demonstrated in the below chart:

Purpose	"Material"	"Knowledge"
Due Diligence	May have a significant impact since the seller's threshold may be higher than the buyer's threshold. As a result, materiality may be quantified in the agreement to make sure both parties are applying the same threshold.	A "knowledge" qualifier may not have any impact as long as there is an identified person who should have the requisite knowledge after due inquiry.
Termination Right	In many cases, "materiality" qualifiers within the tax representations are "scraped" (i.e., excluded) in the bring down representation for closing and all the representations have to be accurate in all "material respects." In such cases, "materiality" qualifiers within the tax representations should not have any impact on the termination right.	As a practical matter, a "knowledge" qualifier should not impact the termination right. If either the buyer or the seller discovers an issue that results in the breach of the applicable representation, then it will be known prior to closing. If the breach is not discovered prior to closing, then the representation would have been treated as not having been breached at the closing even without the "knowledge" qualifier.
Indemnification Right	Depends on whether the "materiality" qualifier is "scraped" for determining both whether a breach of the representation has occurred and for purposes of calculating the damages. If so, then "material" qualifiers should not impact the indemnification right. If not, then the buyer may not be fully indemnified for the breach.	Same as "material" qualifiers.

I. Pre-Closing Covenants



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ARTICLE VI
PRE-CLOSING COVENANTS

ARTICLE VII
POST-CLOSING COVENANTS

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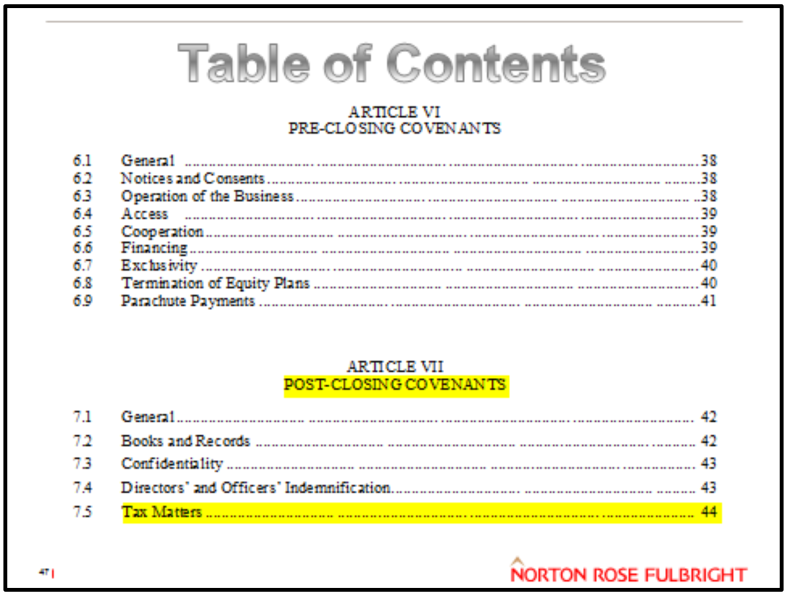
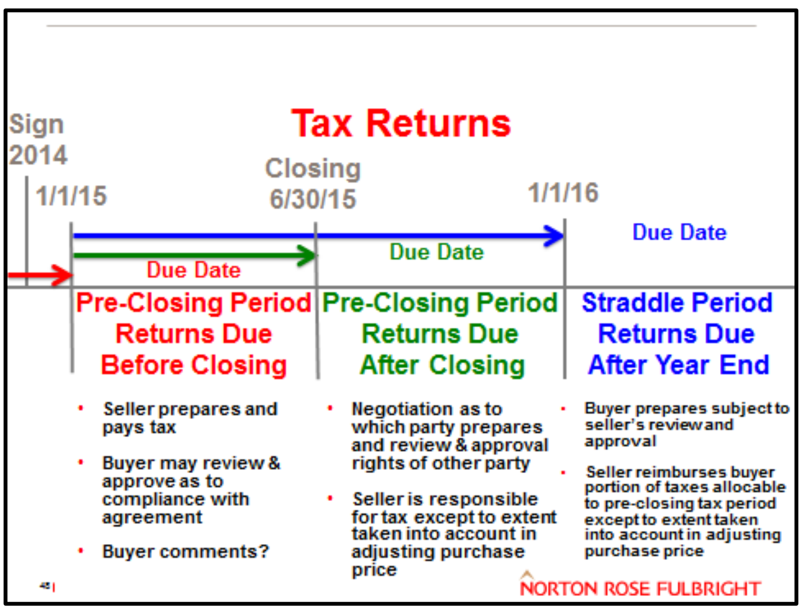
The next item in the hypothetical acquisition agreement that raises tax issues is the "Operation of the Business" provision. During the period between the signing of the acquisition agreement and the closing, the seller will generally be required to maintain the target's business. Buyers generally impose certain restrictive covenants on the seller that require the seller to not take certain actions during such period, including failing to file tax returns, making or changing tax elections, amending tax returns, settling tax controversies, extending statutes of limitation, surrendering refund claims, etc. Although the intent of these provisions is to ensure that the seller continues to conduct the business in the ordinary course, but not take actions that could adversely impact the buyer or target after closing, some restrictive covenants can have the opposite effect if they are drafted too broadly. For example, making elections is generally required in order to prepare and file tax returns. If there is a strict prohibition against making any tax elections, this could be problematic. As a result, the list of items needs to be reviewed by the tax advisors for both parties to ensure that the buyer and target will not be adversely affected by certain actions between signing and closing without the prior consent of the buyer, but allow the seller enough flexibility to actually conduct the target's business prior to closing.

J. Tax Matter Covenants



The next item in the hypothetical acquisition agreement that raises tax issues is the "Tax Matters" provision. The "Tax Matters" section sets forth the parties' agreement concerning the manner in which various tax matters will be addressed, including the preparation and filing of tax returns, payment of taxes, handling of tax controversies, and making certain elections, among others.

If the seller is responsible for the target's taxes for periods or portions thereof that end on or before the closing date ("Pre-Closing Tax Indemnity"), the chart below illustrates various tax returns that may need to be addressed:



If the parties do not address who is responsible for the preparation and filing of tax returns for the target due after the closing, then the buyer will generally have control over those returns since it will be in control of the target. As a result, the seller is generally the party that inserts preparation and review provisions into the acquisition agreement to ensure that it has some control over the issues reflected on the tax return, and therefore, the resulting tax liability for periods or portions of periods that end on or prior to the closing date.

If there is a Pre-Closing Tax Indemnity, the parties will also need to address certain matters relating to tax controversies that arise after the closing but with respect to periods covered by the Pre-Closing Tax Indemnity.

If the acquisition agreement is silent on this point, then the buyer effectively controls since it controls the target. As a result, the seller is generally the party that adds provisions to address the control over such tax controversies. Sellers may take the position that since they are responsible for the resulting tax liability, they should control the tax controversy; however, buyers are often concerned that sellers may "trade" an issue or take some other position that reduces the tax liability for the applicable pre-closing tax period but has the effect of increasing the target's tax liability in future periods. Depending on which party controls the tax controversy, the other party will generally seek rights with respect to notice of the tax controversy, updates concerning the controversy, review and comment rights on positions taken, and require the controlling party's consent prior to any settlement. In the case of straddle periods,[15] the buyer will generally control the tax controversy and the seller will have participation rights. Sometime, buyers and sellers will have "joint" control, which can be challenging to define in the acquisition agreement.

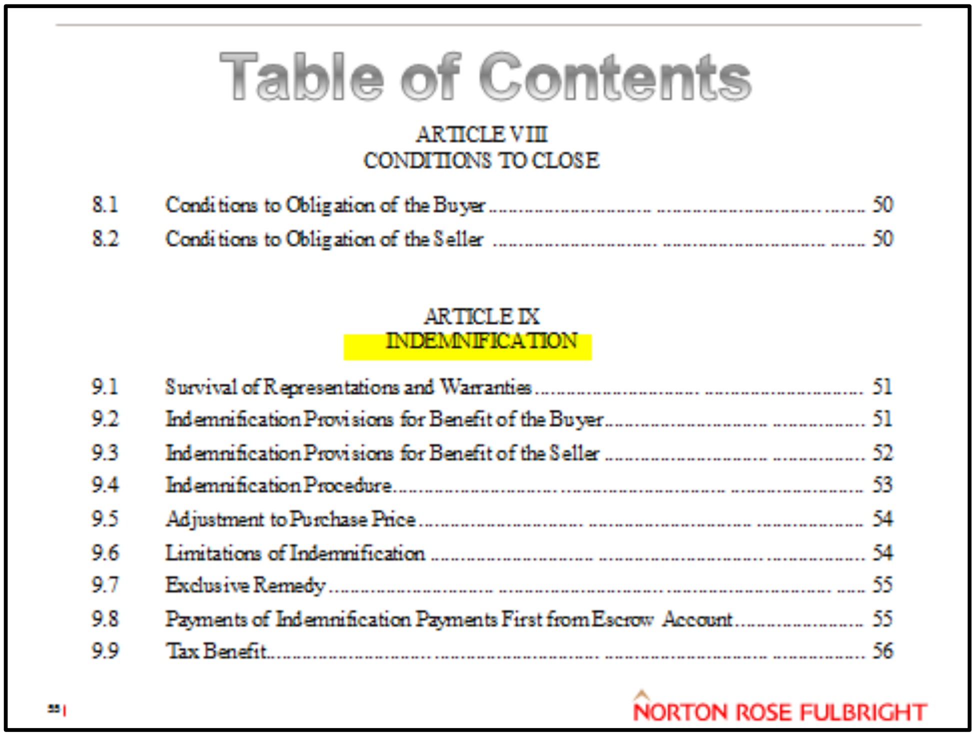
Refunds for pre-closing periods can also be an item that needs to be addressed. If there is a Pre-Closing Tax Indemnity, a seller may include a provision that it is entitled to any refunds for periods or portions thereof that end on or before the closing date. However, buyers will need to limit such refunds to carve out refunds that are attributable to post-closing tax attributes, such as net operating losses, and any refunds that were taken into account for purposes of calculating the purchase price, such as in the working capital adjustment. Additionally, refunds for straddle periods will need to be apportioned in the same matter that the tax liability for such taxes was allocated. A buyer may also seek reimbursement for its expenses in preparing and filing any amended returns that may be required to obtain such refunds.

Buyers and sellers both may want to restrict the ability to file amended returns without its consent, but for different reasons. A buyer does not want an amended return filed if it would have the effect of decreasing the tax liability for a pre-closing tax period that is allocated to the seller, possibly resulting in a refund for the seller, and increasing the tax liability for post-closing tax periods. Conversely, a seller does not want the buyer filing an amended return after the closing that increases the tax liability allocated to seller, resulting in an indemnity claim by buyer against seller, and reducing the tax liability for post-closing periods.

The "tax matters" section may address numerous other issues, including the allocation of transfer taxes, cooperation provisions with to tax controversies and preparing and filing tax returns, terminating tax sharing agreements, an agreement to make certain elections (e.g., IRC § 338(h)(10) election), and the agreed tax treatment of the transaction.

[15] Straddle periods are tax periods that begin on or before the closing date and end after the closing date.

K. Indemnification



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CONDITIONS TO CLOSE

ARTICLE IX
INDEMNIFICATION

NORTON ROSE FULBRIGHT

The next items in the hypothetical acquisition agreement that raise several tax issues are in the "Indemnification" provision. As discussed above, one of the purposes of tax representations is to provide the buyer an indemnity in the event the representation is breached. However, the amount of time a representation survives may be dependent on the type of seller or the target. If the target is a publicly traded company, the tax representations terminate at closing because there is no one to stand behind the representations for purposes of providing an indemnity. In the case of a private seller, tax representations generally survive until the statute of limitation runs, plus a number of days (e.g., 30) in the event the taxing authority makes an assessment on the last day of the statutory period. In the case of a financial seller, such as private equity, the seller may only be willing to allow the representation to survive for some shorter period (e.g., coterminous with the escrow) because the fund intends to distribute the cash shortly after closing. As discussed above, another issue with breaches of tax representations is whether "knowledge" and "material" qualifiers and scheduled items are taken into account for purposes of determining whether there is a breach and the determination of the damages. In most cases, the "knowledge" and "material" qualifiers are "scraped" out of the representation for purposes of the indemnity. Whether scheduled items are "scraped" generally requires more negotiation. Sellers will often argue that there has been disclosure of the issue and the buyer has already take the issue into account in the purchase price. However, a disclosure of an ongoing tax audit, for example, may not provide the buyer with enough information to actually quantify the issue.

In addition to an indemnity for breaches of the tax representations, there is often a separate pre-closing tax indemnity that makes the seller responsible for the taxes of the target for tax periods (or portions thereof) ending on or before the closing date (often referred to as a "your watch, my watch" approach). In such cases, there is a separate allocation provision, usually in the tax matters section discussed above, that addresses straddle periods (i.e., tax periods that begin before and end after the closing date). In the case of income type taxes, the allocation to the pre-closing portion of the straddle period that is for the account of the seller is based on an interim closing of the books. In the case of property type taxes, the portion of such taxes allocated to the pre-closing portion of the straddle period that is for the seller is generally based on the number of days in the tax period ending on the closing date. In some cases, special provisions are needed. For example, certain franchise taxes for the privilege of doing business in the current year are based on the income or capital of the target for the prior year.

The indemnification provisions may impose limitations on the buyer's ability to make indemnification claims. For example, the indemnification provisions may provide that the buyer can only make claims if the indemnification claims exceed a certain threshold in the aggregate and\or place a limitation on the total amount that a buyer can claim. The limitations usually do not apply to "Fundamental Representations," and in many cases the indemnification for pre-closing taxes and breaches of representations are excluded from these limitations as well. The theory being that taxes should be known liabilities that should have been paid or properly accrued. In some cases, particularly private equity, the indemnification will be limited to the amount in escrow and any deferred payments, such as an earnout.

As discussed above, the indemnification for pre-closing taxes and breaches of tax representations should be reduced by the amount of the applicable tax that was taken into account in determining the purchase price, such as a reduction in the working capital adjustment as a result of accrued taxes. Another reduction to the indemnification claims that sellers are inserting more often is a reduction for any associated tax benefits resulting from the claim. The seller's argument is that if the liability is fully indemnified, the buyer receives a "windfall" because the buyer can deduct the liability and receives a tax benefit. However, the buyer has many counter arguments to that assertion, including the following tax arguments:

1. In an asset deal, the liability would have to be capitalized, so there is no current deduction;
2. If the target was a member of a consolidated group, an "S" corporation, or partnership, the deduction should belong to the seller, not the buyer under tax accounting rules; and
3. If the target is a "stand-alone" C corporation, the deduction may be severely limited by built-in loss rules (e.g., IRC § 382).

The buyer also has several valid non-tax arguments as well, including:

1. Determination of any actual tax benefit puts buyer's tax positions and reporting in issue;
2. Puts non-breaching buyer in the position of proving the lack of a tax benefit;
3. Seller will use complexity of determining tax benefit as a means of delaying or frustrating indemnity claims; and
4. Ignores fact that seller's income on the sale is reduced by the indemnity payment.

At bottom, the insertion of a tax benefit provision appears to be more about making the indemnification claim harder for the buyer and confusing the issue, rather than achieving a fair result.[16]

[16] For a good discussion on the validity of tax benefit provisions that makes these and other points, *see* Corrigan and Lundsten, *Buyer Beware: Reduced Indemnity on Account of Supposed (Mythical?) Tax Benefits*, Deal Points, The Newsletter of the Mergers and Acquisitions Committee, Volume XVIII, Issue 1, Winter 2013.

NORTON ROSE FULBRIGHT

Federal Tax Practice Ethics and Circular 230

Richard L. Hunn

December 2016

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I. INTRODUCTION

A. This presentation focuses on administrative practice before the Internal Revenue Service. Hence, it addresses Federal statutes and regulations that govern or relate to practice before the IRS, especially 31 C.F.R. Subtitle A, Part 10, which is known as Circular 230. Circular 230 states that it governs the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and registered tax return preparers before the IRS. However, keep in mind that lawyers are also subject to ethical rules of the states in which they practice, as well as to ethical rules that are adopted by courts in which they practice (typically either the ethical rules of a particular state or the ABA Model Rules). Moreover, the ABA and state bars have from time to time issued ethics opinions with respect to issues relating to tax matters or practice before the IRS. Due to the recent spate of law changes in this area, many of the older opinions are obsolete. The author has included some information regarding ethics opinions related to tax matters or practice before the IRS, but this is not intended to be comprehensive. If a practitioner is confronted with a difficult question it would be advisable to determine whether the ABA or applicable state bar has issued an opinion on the topic.

B. Practice in the area of Federal taxation is subject to Federal regulation and also must be conducted within the framework of the Federal civil and criminal penalty provisions that apply to Federal taxation, the Federal statutes and regulations that apply to tax return preparers, as well as the Federal regulations (Circular 230) that govern practice before the Internal Revenue Service. Failure to observe the norms of these statutes and regulations can result in the imposition of penalties and other sanctions upon individual practitioners and a firm and can jeopardize a firm's continued ability to engage in this practice area.

II. IN GENERAL – ASPIRATIONAL STANDARDS (UNDER CIRCULAR 230)

A. **Best Practices**. Pursuant to Circular 230 § 10.33, tax advisors "should" strive to provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to complying with the standards of practice elsewhere in Circular 230, section 10.33(a) provides that best practices include the following:

1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear

understanding with the client regarding the form and scope of the advice or assistance to be rendered.

2. Establishing the relevant facts, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code (the “Code”) if a taxpayer acts in reliance on the advice.

4. Acting fairly and with integrity in practice before the Internal Revenue Service.

B. Circular 230 § 10.33(b) provides that persons with responsibility for overseeing a firm’s Federal tax practice “should” take reasonable steps to ensure the firm’s procedures are consistent with these best practices.

C. The standards in section 10.33(a) are directory rather than mandatory.

III. IN GENERAL – MANDATORY STANDARDS

A. **Procedures to ensure compliance.** Circular 230 § 10.36 requires that the head a firm’s tax practice must take reasonable steps to ensure that the firm has adequate procedures in place for purposes of complying with Circular 230.

B. **Knowledge of client’s noncompliance, error, or omission**. Circular 230 § 10.21 provides that a practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, learns that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission, and must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

C. **Diligence as to accuracy.** Circular 230 § 10.22 provides that practitioners must exercise due diligence:

1. in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

2. in determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

3. in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

Except as modified by Circular 230 §§ 10.34 and 10.37 (discussed below), a practitioner may rely on the work product of another person if the practitioner used reasonable care in engaging, supervising, training, and evaluating the other person, taking proper account of the nature of the relationship between the practitioner and the other person.

D. **Tax Compliance by Practitioners**. Circular 230 § 10.51(a)(6) makes it a violation of Circular 230 to willfully fail to make a Federal tax return in violation of Federal tax laws, or to willfully evade, attempt to evade, or participate in any way in evading or attempting to evade assessment or payment of any Federal tax.

E. **Taxpayer Checks**. Circular 230 § 10.31 prohibits a practitioner from endorsing or negotiating any check issued to a client by the government in respect of a Federal tax liability.

F. **Notaries.** An attorney may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the IRS and for which the attorney is employed as a representative or is in any way interested. Section 10.26 of Circular 230.

G. **Contingent Fees**. Circular 230 § 10.27 prohibits a practitioner from charging an unconscionable fee in connection with any matter before the Internal Revenue Service. Additionally, Circular 230 § 10.27 prohibits a practitioner from charging a contingent fee (as broadly defined in subsection 10.27(c)(1)), except as follows:

1. For services rendered in connection with the Internal Revenue Service's examination of, or challenge to —

   a. An original tax return; or

   b. An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.

2. For services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

3. For services rendered in connection with any judicial proceeding arising under the Code.

IV. STANDARDS FOR WRITTEN TAX ADVICE

A. **Minimum standards for written tax advice**. Certain minimum standards must be met for any practitioner to issue written advice concerning any Federal tax matters ("written tax advice") in any form (letter, memorandum, email, text message, fax, etc.). Circular 230 § 10.37(a) requires that, in issuing written tax advice, a practitioner must:

1. base the written tax advice on reasonable factual and legal assumptions (including assumptions as to future events);

2. reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

3. use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

4. not rely upon representations, statements, findings or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;

5. relate applicable law and authorities to facts; and

6. in evaluating a Federal tax matter, not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

B. **Reliance in connection with written tax advice.**

1. In issuing written tax advice, reliance on representations, assumptions, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more of such

representations, assumptions, statements, findings, or agreements are incorrect, incomplete, or inconsistent. Section 10.37(a)(3) of Circular 230.

2. In issuing written tax advice, a practitioner may rely on the advice of another person only if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when the practitioner knows or reasonably should know that:

   a. the opinion of the other person should not be relied on;

   b. the other person is not competent or lacks the necessary qualifications to provide the advice; or

   c. the other person has a conflict of interest in violation of the rules described in Circular 230.

   Section 10.37(b) of Circular 230.

V. STANDARDS FOR TAX RETURNS AND REFUND CLAIMS, AND FOR DOCUMENTS, AFFIDAVITS, AND OTHER PAPERS

A. **Preparer tax identification numbers**. Regulations under I.R.C. § 6109 and Circular 230 § 10.8(a) require an individual who for compensation prepares or assists with the preparation of all or substantially all of a Federal tax return or claim for refund to have a preparer tax identification number ("PTIN"). Under Circular 230 § 10.51(a)(17), a practitioner is subject to discipline for willfully preparing all or substantially all of, or signing, a return/claim if the practitioner does not have PTIN. A firm may also be subject to a monetary penalty (under Circular 230 § 10.50(c)(1)(ii)) if the firm knew or reasonably should have known of such conduct.

B. **Tax Return Preparers**. Practitioners should be aware of the broad definition of "tax return preparer" under Circular 230, I.R.C. § 7701(a)(36)(A) and Treas. Reg. § 301.7701-15 (which is even broader than the definition set forth in the preceding paragraph for purposes of requiring a PTIN). Treas. Reg. section 301.7701-15 specifically defines a tax return preparer as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any Federal tax return or claim for refund. This can include advising with respect to a position on a return or claim for refund. Treas. Reg. § 301.7701-15. Persons who are tax return preparers with respect to any one or more positions on a tax return or claim for refund, or with respect to the entire tax return or claim for refund ("position/return/claim") are subject to the requirements of Circular 230, as well as other applicable requirements under the Code and the regulations thereunder, such as Code sections 6694, 6695, 6011, 6713, and 7216, which are briefly discussed below.

C. **Prospective versus completed transactions.** IRS regulations that provide the definitions of tax return preparers make a distinction between advice regarding prospective transactions (which is usually not viewed as tax return preparation) and advice regarding completed transactions (which can be viewed as tax return preparation). See Treas. Reg. §§ 301.7701-15(b)(2), 1.6694-1(b)(6). Moreover, IRS regulations provide that time spent on advice given after events have occurred which represents less than 5% of the aggregate time incurred by an individual with respect to a tax return position is disregarded in determining whether the individual is a non-signing tax return preparer. See Treas. Reg. § 301.7701-15(b)(2)(i). There are ramifications to this. If the advice constitutes tax return preparation, the advisor must have a Preparer Tax Identification Number ("PTIN") and the advice can be subject to penalties under I.R.C. sections 6694 and 6695, which are further discussed below.

D. **Penalties with respect to positions on returns/claims for refund.**

1. I.R.C. § 6694(a) and the regulations thereunder impose a penalty on a tax return preparer who prepares a tax return or claim for refund that takes an "unreasonable position" that results in an understatement of tax. The penalty is the greater of $1,000 or 50 percent of the income derived by the tax return preparer with respect to the position.

   a. In general, a position is considered "unreasonable" unless

      i. there is substantial authority for the position (as defined in Treas. Reg. § 1.6662-4(d)); or

      ii. there is a reasonable basis for the position (as defined in Treas. Reg. § 1.6694-2(d)(2)) and the position is properly disclosed and related advice documented as required under Treas. Reg. § 1.6694-2(d) or other applicable law.

   b. For a tax shelter (as defined in I.R.C. § 6662(d)(2)(C)(ii)) or a reportable transaction to which I.R.C. § 6662A applies, a position is considered "unreasonable" unless it is reasonable to believe that the position would more likely than not be sustained on its merits.

2. I.R.C. § 6694(b) and the regulations thereunder provide a penalty for any understatement of tax on a return or claim for refund that results from (a)

a willful attempt to understate liability or (b) reckless or intentional disregard of rules or regulations. The penalty is the greater of $5,000 or 75 percent of the income derived by the tax return preparer with respect to the position.

E. **Circular 230 § 10.34(a)(1).** The standards under section 6694 are reiterated in Circular 230 § 10.34(a)(1), which provides that a practitioner may not sign a tax return or claim for refund, advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position, that:

1. Lacks a reasonable basis;

2. Is an unreasonable position as described in I.R.C. § 6694(a)(2) and regulations thereunder, or other published guidance; or

3. Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in I.R.C. § 6694(b)(2).

F. **Other penalties with respect to preparation of returns/claims for refund**. I.R.C. § 6695 provides for various other penalties with respect to preparation of a return or claim for refund, for such things as failing to furnish a copy of the return to the taxpayer, failing to sign the return when required by regulations to do so, failing to furnish an identifying number (i.e., PTIN), and failing to retain copies of prepared returns/claims or lists of such returns/claims. Most are $50 per violation.

G. **E-Filing**. I.R.C. § 6011(e)(3) and the regulations and rules thereunder impose electronic filing requirements on tax return preparers with respect to "individual income tax returns" (which are defined as Federal income tax returns for individuals, estates and trusts), unless the preparer's firm reasonably expects to file 10 or fewer of such returns during a calendar year. Currently, amended individual income tax returns and certain other returns are not accepted electronically by the IRS, and so are not counted. See Treas. Reg. § 301. 6011-7(c)(2), (d)(1); Notice 2011-26, 2011-17 I.R.B. 720 (3/28/2011). Additionally, if the tax return preparer obtains a hand-signed and dated statement from the taxpayer that the taxpayer chooses to file the return in paper format and that the taxpayer (and not the preparer) will submit the paper return to the IRS, then the return will not be counted. See Treas. Reg. § 301.6011-7(a)(4)(ii), (d)(1); Rev. Proc. 2011-25, 2011-17 I.R.B. 725 (3/28/2011). Circular 230 § 10.51(a)(16) makes it a violation of Circular 230 to willfully fail to file on magnetic or other electronic media a return prepared by a practitioner when the practitioner is required to do so, unless the failure is due to reasonable cause and not willful neglect.

H. **Restrictions on Disclosure or Use of Tax Return Information.** I.R.C. §§ 6713 and 7216 are civil and criminal penalty statutes that prohibit the disclosure or use of information obtained in connection with tax return preparation except in certain circumstances, including as permitted by the IRS in regulations. In addition to penalties under those statutes, Circular 230 § 10.51(a)(15) makes it a violation of Circular 230 to willfully disclose a tax return or tax return information in a manner not authorized by the Code. Permissible disclosures and uses are set out in section 7216(b) and the regulations thereunder at Treas. Reg. §§ 301.7216-2 and 3. They include (leaving out a few that are more esoteric), **in summary** (see the regulations for particulars):

1. use of such information to prepare a taxpayer's state, local or foreign tax returns (but see below regarding disclosure);

2. use and disclosure of such information in connection with the preparation of returns of certain related taxpayers;

3. disclosure pursuant to a court order, a subpoena issued by a grand jury or by Congress, or a summons or subpoena issued by a government agency;

4. disclosure to the IRS;

5. disclosure to other members of the tax return preparer's firm located within the United States for purposes of tax return preparation (disclosure to other members located outside of the United States requires written consent of the client, unless the taxpayer's initial disclosure was to a tax return preparer located outside of the United States);

6. disclosure to other tax return preparers located within the United States for purposes of tax return preparation (so long as the recipient makes no substantive determinations or advice);

7. disclosure to contractors for purposes of tax return preparation (with a written notice about sections 6713 and 7216 required to be provided to such contractors);

8. disclosure to an attorney for purposes of securing legal advice;

9. for law and accounting firms, use of or disclosure to other members of the firm for purposes of providing other legal or accounting services (but not to related or affiliated firms unless the taxpayer provides written consent), as well as disclosure to third parties in the normal course of rendering legal or accounting services to the taxpayer;

10. disclosure to the taxpayer's fiduciary in certain circumstances;

11. maintaining a list of the tax return preparer's customers for purposes of providing educational information to them or soliciting additional tax return preparation business from them;

12. to produce certain kinds of statistical compilations of data that are anonymous as to particular taxpayers, but only for purposes of internal management and support of the tax return preparation business (which can include marketing in support of the tax return preparation business but not other lines of business) or for bona fide research or public policy discussions concerning state or federal taxation;

13. for quality, peer or conflict reviews;

14. pursuant to written consent of the taxpayer in the manner set out in Treas. Reg. § 301.7216-3. However:

    a. a tax return preparer may not request a taxpayer's consent to disclose or use tax return information for purposes of solicitation of business unrelated to tax return preparation after the tax return preparer provides a completed tax return to the taxpayer for signature;

    b. if a taxpayer has declined a request for consent to the disclosure or use of tax return information for purposes of solicitation of business unrelated to tax return preparation, the tax return preparer may not solicit another consent;

    c. unless otherwise specified, a consent is only valid for one year.

I. **Definitions of Tax Return and Tax Return Information.** The definitions of tax return and tax return information for purposes of sections 6713 and 7216 are set out in Treas. Reg. § 301.7216-1(b), summarized as follows:

1. Tax return – An original or amended income tax return (consequently, employment tax, estate tax, gift tax, and various kinds of excise tax returns are not implicated);

2. Tax return preparer – Any person who: (a) is engaged in the business of preparing or assisting in preparing tax returns, (b) is engaged in the business of providing auxiliary services in connection with the preparation of tax returns, (c) is compensated for preparing or assisting in preparing a tax return for any other person, or (d) employees of any such foregoing person who assist in the preparation of, or provide auxiliary services in connection with, the preparation of a tax return.

3. Tax return information – This means any information (including, but not limited to, a taxpayer's name, address, or identifying number) which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer. This includes information furnished to the tax return preparer by the taxpayer or a third party. It also includes information derived or generated by the tax return preparer from such information in connection with the preparation of the tax return. It also includes information received by the tax return preparer from the IRS in connection with the processing of the return, including an acknowledgment of acceptance or notice of rejection of an electronically filed return. The term does not include information identical to any tax return information furnished to the tax return preparer if the identical information was obtained other than in connection with the preparation of a tax return.

J. **Standards for documents, affidavits, and other papers.** Circular 230 § 10.34(b) provides that:

1. A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

2. A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service—

    a. The purpose of which is to delay or impede the administration of the Federal tax laws;

    b. That is frivolous; or

c. That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

K. **Advising clients concerning potential penalties and disclosure.** Circular 230 § 10.34(c) provides that:

1. A practitioner must inform a client if there are any penalties that are reasonably likely to apply to the client with respect to—

a. A position taken on a tax return if the practitioner advised the client with respect to the position, or the practitioner prepared or signed the tax return.

b. Any document, affidavit or other paper submitted to the Internal Revenue Service.

2. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

L. **Relying on information furnished by clients and others**

1. Circular 230 § 10.34(d) provides that a practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. *See also* Treas. Reg. § 1.6694-1(e)(1).

2. A tax return preparer may also rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm) who the taxpayer believed was competent to render the advice or other information. Treas. Reg. §§ 1.6694-1(e)(1), 1.6694-2(d)(2), 1.6694-2(e)(5).

3. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete. Circular 230 § 10.34(d); Treas. Reg. §

1.6694-1(e)(1). A tax return preparer is not considered to have relied on advice or information in good faith if the advice or information is unreasonable on its face, the tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts, or the tax return preparer knew or should have known that the advice or information was no longer reliable due to developments in the law. Treas. Reg. § 1.6694-2(e)(5).

M. **Reporting requirement for signing tax return preparers**. I.R.C. § 6060 and the regulations thereunder require that a firm maintain a list of each of its practitioners who was a "signing tax return preparer" for each 12-month period ending June 30.

VI. MATERIAL ADVISORS

A. **Requirements.**

1. I.R.C. § 6111 requires that a person who is a material advisor with respect to a reportable transaction make a return identifying and describing the transaction and the potential tax benefits.

2. I.R.C. § 6112 requires that a person who is a material advisor with respect to a reportable transaction maintain a list of advisees.

B. **Material Advisor.** A material advisor is defined in I.R.C. § 6111(b)(1) as a person who provides material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out a reportable transaction, and who derives gross income in excess of:

1. $50,000, if substantially all of the tax benefits are provided to natural persons, or

2. $250,000, in any other case.

C. **Reportable Transaction.** A reportable transaction is defined in the regulations under I.R.C. § 6011, specifically at Treas. Reg. § 1.6011-4(b). Reportable transactions include:

1. Transactions identified by the IRS as listed transactions;

2. Transactions where confidentiality is imposed on the taxpayer client and the advisor receives a fee of at least:

a. $250,000 if the taxpayer is a corporation, or a partnership or trust all of the owners or beneficiaries of which are corporations;

b. $50,000 for all other transactions;

3. Transactions with contractual protection as to fees: where the taxpayer is entitled to a full or partial refund of fees if the tax treatment of the transaction is not sustained or where the fees are contingent on the realization of tax benefits;

4. Transactions identified by the IRS as transactions of interest; or

5. Transactions that result in a taxpayer claiming a loss under I.R.C. § 165 of at least:

a. $10 million in one taxable year or $20 million in a combination of taxable years for corporations, or partnerships that have only corporations as partners;

b. $2 million in one taxable year or $4 million in a combination of taxable years for partnerships, individuals, S corporations, or trusts; or

c. $50,000 in one taxable year for individuals or trusts if the loss arises from a section 988 transaction.

D. **Penalties.**

1. I.R.C. § 6707 imposes a penalty on a material advisor for failure to file a return with respect to a reportable transaction. The penalty is $50,000, unless the transaction is a listed transaction, in which case the penalty is the greater of $200,000 or 50 percent of the income derived by such person (75 percent if the failure was intentional) with respect to the transaction.

2. I.R.C. § 6708 imposes a penalty on a material advisor for failure to maintain a list of advisees with respect to a reportable transaction. If the IRS requests the list and does not receive it within 20 business days, the penalty is $10,000 for each subsequent day that passes, unless such failure for such day is due to reasonable cause. Regulations under section 6708 allow a material advisor to show in support of a reasonable cause defense that it established and adhered to procedures reasonably

designed and implemented to ensure compliance with list maintenance requirements under section 6112.

VII. OTHER STANDARDS

A. Other requirements or standards not covered in detail in this outline that practitioners should be aware of are set out more fully within the authorities referenced below:

1. standards under Circular 230 § 10.29 and applicable rules of professional conduct regarding conflicts of interest;

2. standards under Circular 230 § 10.25, applicable rules of professional conduct and Federal laws regarding practice by former government employees;

3. standards under Circular 230 § 10.30, applicable rules of professional conduct, and American Bar Association and applicable State bar requirements regarding solicitation or advertising;

4. standards under Circular 230 §§ 10.28 and 10.51(a)(8) and applicable rules of professional conduct regarding returning or safekeeping a client's records or other property;

5. standards under Circular 230 § 10.51 regarding incompetence and disreputable conduct for which an attorney may be sanctioned; and

6. to the extent applicable (and not overridden by more stringent standards subsequently imposed by statutes, regulations or Circular 230), standards under ABA and State Bar ethics opinions, including, but not limited to:

    a. ABA Formal Opinion 346 dated January 29, 1982 regarding "Tax Law Opinions in Tax Shelter Investment Offerings";

    b. ABA Formal Opinion 85-352 dated July 7, 1985 regarding "Tax Return Advice; Reconsideration of Formal Opinion 314";

    c. ABA Informal Opinion 1470 dated July 16, 1981 regarding "Duty of Lawyer to Inquire into Fraudulent or Criminal Conduct and Disclose Past Activities of a Prospective Client";

d. Texas Opinion 438 (March 1987) regarding retention and supervision of a non-lawyer accountant to perform tax services for law firm clients;

e. Texas Opinion 545 (October 2002) regarding retention by, and contingent fee arrangements with, a governmental taxing unit for collecting delinquent taxes; and

f. Texas Opinion 620 (October 2012) regarding engagement of a lawyer by a nonlawyer agent to represent a property owner in a property tax matter.

VIII. CASE LAW REGARDING "PRACTICE" BEFORE IRS

A. *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 917 F. Supp. 2d 67 (D.D.C. 2013). In *Loving*, several tax return preparers who were not attorneys, CPAs, enrolled agents or enrolled actuaries sued for an injunction against the IRS in the federal district court for the District of Columbia on grounds that they were not practicing before the Internal Revenue Service and thus could not be regulated under Circular 230 (as "registered tax return preparers"). The district court sided with the plaintiff tax return preparers and granted the injunction. The D.C. Circuit affirmed, holding that mere preparation and filing of tax returns does not constitute practice before the IRS.

B. *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014). The district court in *Ridgely* followed the holding in *Loving* and held that preparation of an ordinary refund claim before filing a power of attorney with the IRS does not constitute practice before the IRS, so the IRS cannot under Circular 230 § 10.27 prohibit the charging of a contingent fee for preparing such a refund claim.

C. **Ramifications**. It is not advisable to rely on the rulings in *Loving* and *Ridgely* for several reasons. Those cases are binding precedent only in the D.C. Circuit and the District Court for the District of Columbia. The IRS has not acquiesced to the holdings in those cases, and no other court has addressed these issues. Moreover, the standards for return preparation are largely stated in the Code (e.g., I.R.C. § 6694) and the underlying regulations and are simply reiterated in Circular 230.

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Federal Tax Practice Ethics and Circular 230

Richard L. Hunn

Norton Rose Fulbright
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Federal Tax Practice Ethics and Circular 230

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I. INTRODUCTION

A. This presentation focuses on administrative practice before the Internal Revenue Service. It addresses Federal statutes and regulations that govern or relate to practice before the IRS, especially 31 C.F.R. Subtitle A, Part 10, which is known as Circular 230.

B. Failure to observe the norms of these statutes and regulations can result in the imposition of penalties and other sanctions upon individual practitioners and a firm and can jeopardize a firm's continued ability to engage in this practice area.

II. IN GENERAL – ASPIRATIONAL STANDARDS (UNDER CIRCULAR 230)

A. Best Practices. Circular 230 § 10.33(a) provides that tax advisors "should" adhere to best practices, including:

1. Communicating clearly with the client regarding the terms of the engagement.
2. Establishing the relevant facts, relating applicable law, and arriving at a conclusion supported by the law and the facts.
3. Advising the client regarding the import of the conclusions reached, including penalties.
4. Acting fairly and with integrity in practice before the IRS.

B. Circular 230 § 10.33(b) provides that persons with responsibility for overseeing a firm's Federal tax practice "should" take reasonable steps to ensure procedures consistent with best practices.

C. These standards are directory rather than mandatory.

III. IN GENERAL – MANDATORY STANDARDS

A. **Procedures to ensure compliance.** Circular 230 § 10.36 requires the head of a firm's tax practice to put adequate procedures in place.

B. **Knowledge of client's noncompliance, error, or omission.** Circular 230 § 10.21 provides that a practitioner must advise the client promptly of the fact of noncompliance, error, or omission and of consequences under the Code and regulations.

C. **Diligence as to accuracy**. Circular 230 § 10.22 provides that practitioners must exercise due diligence:

1. in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers;
2. in determining the correctness of oral or written representations made by the practitioner to the IRS; and
3. in determining the correctness of oral or written representations made by the practitioner to clients.

D. **Tax Compliance by Practitioners.** Circular 230 § 10.51(a)(6) makes it a violation of Circular 230 to willfully fail to make a Federal tax return, or to willfully evade, attempt to evade, or participate in any way in evading or attempting to evade assessment or payment of any Federal tax.

E. **Taxpayer Checks.** Circular 230 § 10.31 prohibits a practitioner from endorsing or negotiating any check issued to a client by the government in respect of a Federal tax liability.

F. **Notaries.** Circular 230 § 10.26 provides that an attorney may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the IRS and for which the attorney is employed as a representative or is in any way interested.

G. Contingent Fees. Circular 230 § 10.27 prohibits a practitioner from charging a contingent fee (as broadly defined in subsection 10.27(c)(1)), except:

1. For services rendered in connection with the IRS's examination of, or challenge to —
   a. An original tax return; or
   b. An amended return or claim for refund or credit where it was filed within 120 days of the taxpayer receiving a written notice of examination of, or a written challenge to the original tax return.
2. For services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS.
3. For services rendered in connection with any judicial proceeding arising under the Code.

IV. STANDARDS FOR WRITTEN TAX ADVICE

A. Minimum standards for written tax advice. Circular 230 § 10.37(a) requires that a practitioner:

1. base the written tax advice on reasonable factual and legal assumptions;
2. reasonably consider all relevant facts and circumstances;
3. use reasonable efforts to identify and ascertain the relevant facts;
4. not rely upon representations, statements, findings or agreements if reliance would be unreasonable;
5. relate applicable law and authorities to facts; and
6. not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

B. Reliance in connection with written tax advice

1. Reliance on representations, assumptions, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more are incorrect, incomplete, or inconsistent. Circular 230 § 10.37(a)(3).
2. Per Circular 230 § 10.37(b), a practitioner may rely on the advice of another person only if the advice was reasonable and the reliance is in good faith. Reliance is not reasonable when the practitioner knows or reasonably should know that:
   a. the opinion of the other person should not be relied on;
   b. the other person is not competent or lacks the necessary qualifications; or
   c. the other person has a conflict of interest.

V. STANDARDS FOR TAX RETURNS AND REFUND CLAIMS, AND FOR DOCUMENTS, AFFIDAVITS, AND OTHER PAPERS

A. **Preparer tax identification numbers**. Regulations under I.R.C. § 6109 and Circular 230 § 10.8(a) require an individual who for compensation prepares or assists with the preparation of all or substantially all of a Federal tax return or claim for refund to have a preparer tax identification number ("PTIN").

B. **Tax Return Preparers**. Practitioners should be aware of the broad definition of "tax return preparer" under Circular 230, I.R.C. § 7701(a)(36)(A) and Treas. Reg. § 301.7701-15. A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any Federal tax return or claim for refund. This can include advising with respect to a position on a return or claim for refund.

C. **Prospective versus completed transactions.** IRS regulations that provide the definitions of tax return preparers make a distinction between advice regarding prospective transactions (which is usually not viewed as tax return preparation) and advice regarding completed transactions (which can be viewed as tax return preparation). See Treas. Reg. §§ 301.7701-15(b)(2), 1.6694-1(b)(6).

- Advice given after the transaction which represents less than 5% of the aggregate time is disregarded.
- Ramifications. If advice constitutes return preparation:
  - the advisor must have a PTIN
  - the advice can be subject to penalties under I.R.C. sections 6694 and 6695 (discussed below).

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D. Penalties with respect to positions on returns/claims for refund.

1. I.R.C. § 6694(a) imposes a penalty on a tax return preparer who prepares a tax return or claim for refund that takes an "unreasonable position" that results in an understatement of tax. A position is unreasonable unless:
   a. there is substantial authority for the position; or
   b. there is a reasonable basis for the position and it is properly disclosed; or
   c. in the case of a tax shelter or reportable transaction, it is reasonable to believe that the position would more likely than not be sustained.
2. I.R.C. § 6694(b) and the regulations thereunder provide a penalty for any understatement of tax on a return or claim for refund that results from (a) a willful attempt to understate liability or (b) reckless or intentional disregard of rules or regulations.

E. Circular 230 § 10.34(a)(1). The standards under section 6694 are reiterated in Circular 230 § 10.34(a)(1).

F. **Other penalties with respect to preparation of returns/claims for refund**. I.R.C. § 6695 imposes various other penalties with respect to preparation of a return or claim for refund, for example, failure to furnish a copy to the taxpayer, failure to sign the return, failure to furnish a PTIN, and failure to retain copies or lists of returns. Most are $50 per violation.

G. **E-Filing.** I.R.C. § 6011(e)(3) and the regulations and rules thereunder impose electronic filing requirements on tax return preparers with respect to "individual income tax returns".

- If the preparer obtains a hand-signed and dated statement from the taxpayer that the taxpayer chooses to file the return in paper format and will submit it to the IRS, the return will not be counted.
- Circular 230 § 10.51(a)(16) makes it a violation of Circular 230 to willfully fail to file electronically a return prepared by a practitioner when the practitioner is required to do so.

H. **Restrictions on Disclosure or Use of Tax Return Information**. I.R.C. §§ 6713 and 7216 prohibit the disclosure or use of information obtained in connection with tax return preparation except in certain circumstances, including, in summary:

1. to prepare a taxpayer's state, local or foreign tax returns;
2. preparation of returns of certain related taxpayers;
3. disclosure pursuant to a court order, or a government summons or subpoena;
4. disclosure to the IRS;
5. disclosure to other members of tax return preparer's firm located within U.S. for purposes of tax return preparation;
6. disclosure to other tax return preparers located within U.S. for certain tax return preparation purposes;
7. disclosure to contractors for purposes of tax return preparation;
8. disclosure to an attorney for purposes of securing legal advice;
9. for law and accounting firms, use of or disclosure to other members of firm for purposes of providing other legal or accounting services;
10. disclosure to the taxpayer's fiduciary in certain circumstances;
11. maintaining a list of the tax return preparer's customers for certain purposes;
12. to produce certain kinds of statistical compilations of data;
13. for quality, peer or conflict reviews;
14. pursuant to written consent of the taxpayer in the manner set out in Treas. Reg. § 301.7216-3.

I. **Definitions of Tax Return and Tax Return Information**. For purposes of sections 6713 and 7216:

1. Tax return – An original or amended income tax return.
2. Tax return preparer – Any person who: (a) is engaged in the business of preparing or assisting in preparing tax returns, (b) is engaged in the business of providing auxiliary services, (c) is compensated for preparing or assisting in preparing a tax return for any other person, or (d) employees of any such foregoing person who assist in preparation.
3. Tax return information – This means any information furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer.

J. **Standards for documents, affidavits, and other papers**. Circular 230 § 10.34(b) provides:

1. A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the IRS unless the position is not frivolous.
2. A practitioner may not advise a client to submit a document, affidavit or other paper to the IRS—
   a. The purpose of which is to delay or impede the administration of the Federal tax laws;
   b. That is frivolous; or
   c. That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

K. **Advising clients concerning potential penalties and disclosure**. Circular 230 § 10.34(c) provides:

1. A practitioner must inform a client if there are any penalties that are reasonably likely to apply to the client with respect to:
   a. A position taken on a tax return; or
   b. Any document, affidavit or other paper submitted to the IRS.
2. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

L. **Relying on information furnished by clients**. Under Circular 230 § 10.34(d), a practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the IRS may rely in good faith without verification upon information furnished by the client. Regulations under I.R.C. § 6694 also allow a tax return preparer to rely in good faith on information or advice from others.

- The practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner.
- The practitioner must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

M. **Reporting requirement for signing tax return preparers**. I.R.C. § 6060 and the regulations thereunder require that a firm maintain a list of each of its practitioners who was a “signing tax return preparer” for each 12-month period ending June 30.

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VI. MATERIAL ADVISORS

A. Requirements.

1. I.R.C. § 6111 requires that a material advisor with respect to a reportable transaction make a return.
2. I.R.C. § 6112 requires that a material advisor with respect to a reportable transaction maintain a list of advisees.

B. Material Advisor. Defined in I.R.C. § 6111(b)(1) as a person who provides material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out a reportable transaction, and who derives gross income in excess of:

1. $50,000, if substantially all the tax benefits provided to natural persons, or
2. $250,000, in any other case.

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C. **Reportable Transaction.** Defined in Treas. Reg. § 1.6011-4(b). Reportable transactions include:

1. Transactions identified by the IRS as listed transactions;
2. Transactions where confidentiality is imposed on the taxpayer client and the advisor receives a fee of at least:
   a. $250,000 if the taxpayer is a corporation, or a partnership or trust all of the owners or beneficiaries of which are corporations;
   b. $50,000 for all other transactions;
3. Transactions with contractual protection as to fees;
4. Transactions identified by the IRS as transactions of interest; or
5. Section 165 loss transactions:
   a. $10 million in one taxable year or $20 million in a combination of taxable years for corporations, or partnerships that have only corporations as partners;
   b. $2 million in one taxable year or $4 million in a combination of taxable years for partnerships, individuals, S corporations, or trusts; or
   c. $50,000 in one taxable year for individuals or trusts if the loss arises from a section 988 transaction.

D. Penalties.

1. I.R.C. § 6707 imposes a penalty on a material advisor for failure to file a return with respect to a reportable transaction:
   - $50,000
   - But for a listed transaction: greater of $200,000 or 50 percent of income derived from transaction (75% if failure was intentional)
2. I.R.C. § 6708 imposes a penalty on a material advisor for failure to maintain a list of advisees with respect to a reportable transaction:
   - $10,000 per day for failure to provide within 20 business days of IRS request

VII. OTHER STANDARDS

A. Other requirements or standards not covered in detail in this outline that practitioners should be aware of are set out more fully within the authorities referenced below:

1. standards under Circular 230 § 10.29 and applicable rules of professional conduct regarding conflicts of interest;
2. standards under Circular 230 § 10.25, applicable rules of professional conduct, and Federal laws regarding practice by former government employees;
3. standards under Circular 230 § 10.30, applicable rules of professional conduct, and American Bar Association and applicable State bar requirements regarding solicitation or advertising;
4. standards under Circular 230 §§ 10.28 and 10.51(a)(8) and applicable rules of professional conduct regarding returning or safekeeping a client's records or other property;
5. standards under Circular 230 § 10.51 regarding incompetence and disreputable conduct for which an attorney may be sanctioned; and
6. to the extent applicable (and not overridden by more stringent standards subsequently imposed by statutes, regulations or Circular 230), standards under ABA and State Bar ethics opinions.

VIII. CASE LAW REGARDING "PRACTICE" BEFORE IRS

A. *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), *aff'g* 917 F. Supp. 2d 67 (D.D.C. 2013). Involved tax return preparers who were not attorneys, CPAs or enrolled agents. Held that mere preparation and filing of returns does not constitute practice before the IRS and thus could not be regulated under Circular 230.

B. *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014). Followed *Loving* and held that preparation of an ordinary refund claim before filing a power of attorney with the IRS does not constitute practice before the IRS, so the IRS cannot prohibit charging a contingent fee under Circular 230 § 10.27.

C. **Ramifications.** Not advisable to rely on these cases. They constitute binding precedent only in D.C. Circuit and District of Columbia. IRS has not acquiesced, and no other court has addressed.

NORTON ROSE FULBRIGHT

Intellectual Property and the Texas Tax Code

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*The views contained in this presentation do not reflect the views of the Texas Comptroller of Public Accounts.

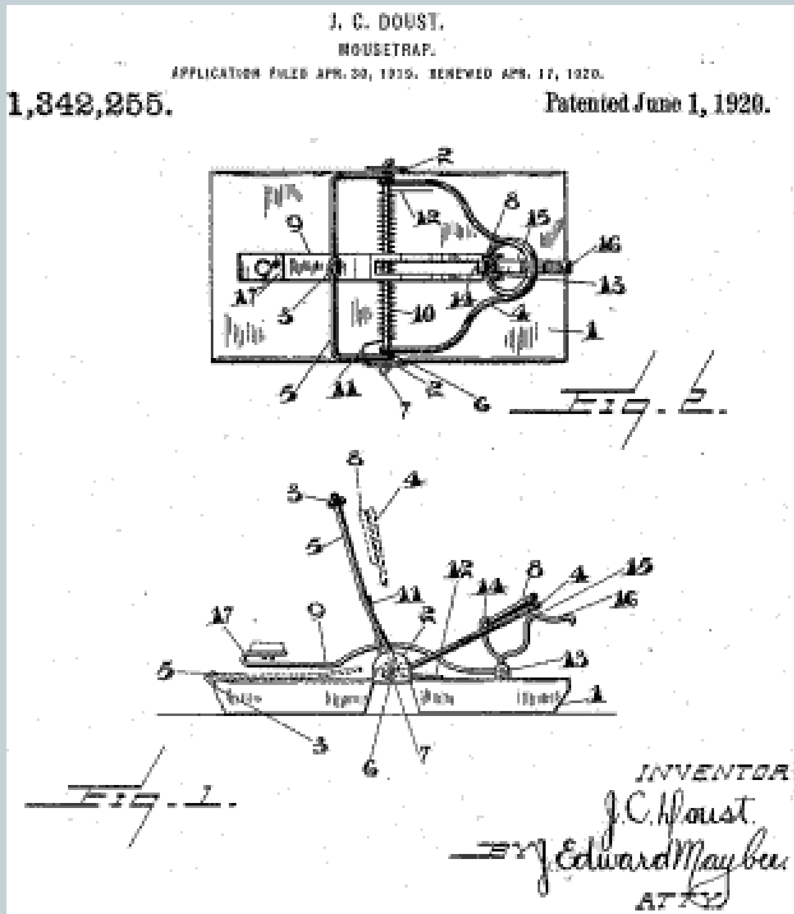
Intellectual Property

- PATENT
- TRADEMARK
- TRADE SECRET
- COPYRIGHT

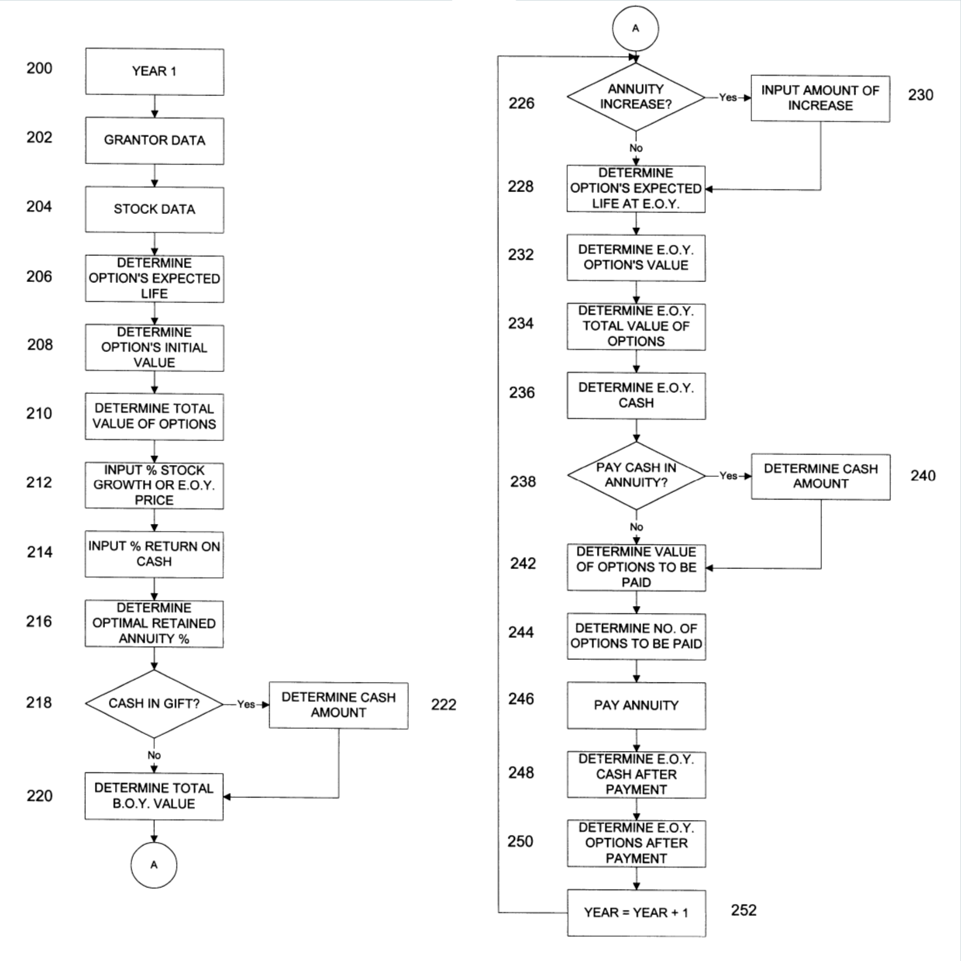
Patent

- Any person who "invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent." 35 U.S. Code § 101
- Claimed invention must be new and non-obvious. 35 U.S. Code §§ 102 and 103.
- U.S. Patent and Trademark Office (PTO)

Mousetrap?


J. C. DOUST.
MOUSETRAP.
APPLICATION FILED APR. 30, 1919. RENEWED APR. 17, 1920.
1,342,255.
Patented June 1, 1920.
FIG. 2.
FIG. 1.
INVENTOR
J.C. Doust.
BY J. Edward Maybee
ATTY

Tax Planning Strategy?



Trademark

Trade Secrets

- Texas Uniform Trade Secrets Act (TUTSA)
  - Civil Practice and Remedies Code, Chapter 134A
  - Effective Sept. 1, 2013
- Defines "trade secret" as:

  "**information**, including a formula, pattern, compilation, program, device, method, technique, process, financial data, or list of actual or potential customers or suppliers that:

  (A) derives independent **economic value**, actual or potential, **from not being generally known** to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and

  (B) is the subject of **efforts** that are reasonable under the circumstances **to maintain** its **secrecy**."

Copyright

U.S. Constitution, Article 1, Section 8

- The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States;...

- To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries;

Statutory Framework

- Copyright is solely a creature of statute; whatever rights and remedies exist do so only because Congress provided them.

  – *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 431, (1984)

- A sales tax is the creature of the legislature and must be interpreted by the courts as written.

  – *Calvert v. Canteen Co.*, 365 S.W.2d 662, 665 (Tex. Civ. App. Austin 1963)

Copyright Act of 1976

- Title 17 of the United States Code
- Protects original works of authorship fixed in any tangible medium of expression
- Protects only the expression of the idea, not the idea itself

> "In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work." 17 U.S. Code § 102(b)

Copyright Act of 1976

- Works of authorship include:
  - (1) literary works;
  - (2) musical works, incl. accompanying words;
  - (3) dramatic works, incl. any accompanying music;
  - (4) pantomimes and choreographic works;
  - (5) pictorial, graphic, and sculptural works;
  - (6) motion pictures and other audiovisual works;
  - (7) sound recordings; and
  - (8) architectural works.
- Computer programs?

Computer Program?

- A computer program is a "work of authorship"
  - Specifically, a “literary work”
  - *Atari Games Corp. v. Nintendo of Am., Inc., 975 F.2d 832, 838 (Fed. Cir. 1992)* ("As literary works, copyright protection extends to computer programs.")
- Software code loaded onto an electronic memory device meets the requirement of "fixation.”
  - 18 Am Jur 2d Copyright and Literary Property § 53

Copyright Act of 1976

- Copyright is the property of the author
- Only the author, or those deriving their rights through the author, can rightfully claim authorship
- Work made for hire
  - The employer, and not the employee, is considered to be the author
  - Includes work prepared by an employee within the scope of his or her employment, or a work specially commissioned, if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire.
  - See 17 U.S. Code § 101

Copyright

- Copyrights have the attributes of personal property, including the owner's right to exclude others from using his or her property.

- Ownership of a copyright is distinct from ownership of any material object in which the work is embodied.

– *Sprinkler Warehouse, Inc. v. Systematic Rain, Inc.*, 859 N.W.2d 527 (Minn. Ct. App. 2015).

Copyright

- The work is separate and distinct from the copyright.
- It is the rights, not the work, that the copyright holder owns.
- The transfer of ownership of any material object does not convey any rights in the copyrighted work.
- Conversely, the sale or transfer of copyright ownership, or of any exclusive rights of copyright, does not convey any right in the material object.

– 18 Am Jur 2d Copyright and Literary Property § 75

Copyright Act of 1976

1. to reproduce the copyrighted work in copies or phonorecords;
2. to prepare derivative works based upon the copyrighted work;
3. to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
4. in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
5. in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly; and
6. in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

Copyright

Copyright

“Copyright Basics,” United States Copyright Office

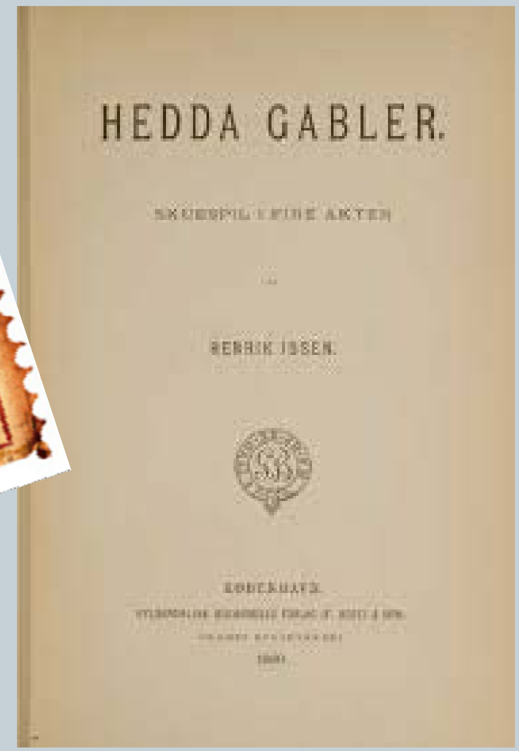
available at:
http://www.copyright.gov/circs/circ01.pdf

Texas Tax Code

- SALES AND USE TAX
- FRANCHISE TAX

Copyright & Sales Tax

- Copyright is an intangible asset
- But it protects a “fixed expression”
- Example: a theatrical production
  - Script
  - Tickets
  - Recording



Copyright & Sales Tax

- "[I]t is clear that some transfers of information on particular mediums of tangible personal property are subject to the sales tax….
- "[I]t is generally conceded that items such as books and record albums, while transferring information, are subject to the sales tax." Comptroller's Decision No. 12,110 (1981) (STAR Accession No. 8111H0421E02)

Computer Programs

- "A set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result." **17 U.S. Code § 101**

- "A series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, punched cards, printed instructions, or other tangible or electronic media." **Tex. Tax Code § 151.0031**

Computer Programs

- For sales and use tax purposes, computer programs are tangible personal property
  - Legislature’s response to *First National Bank v. Bullock*
  - House Bill 122, 68th Legislature, 2d Called Session, amended the definition of “tangible personal property” to include “a computer program that is not a custom program”
  - Since 1987, no distinction between custom and canned computer programs
- Sales tax due on the sale, lease or license of a computer program
  - *See* Rule 3.308(b)(2)
  - *See also Verizon Business Network Services v. Combs*, 07-11-00025-CV (Tex.App.—Amarillo, Apr. 3, 2013)

Meanwhile, in California…

- State Board of Equalization audits Nortel Networks, Inc. and assesses tax on Nortel's license of switch-specific software to Pacific Bell
- California does not tax property transferred under a Technology Transfer Agreement (TTA). Cal. Rev. & Tax. Code §§ 6011 and 6012
- Court of Appeals holds the license of switch-specific software was a TTA exempt from sales and use tax. *See Nortel Networks, Inc. v. State Bd. of Equalization*, 191 Cal. App. 4th 1259 (2011)

Computer Programs

- "Contract programming" is not a taxable service
  - "If a programmer's customer obtains exclusive or legal rights of ownership of the created program, then the programmer is not considered to have sold the computer program, but instead is considered to have performed a service for that customer and that service is not taxable....
  - "In contrast, a programmer, who designs and creates a specific program based on the needs of a customer but who retains the rights to the created program, is considered to have sold that computer program and is a seller of tangible personal property." Comptroller's Decision No. 44,668 (2004).
  - *See also* Rule 3.308(b)(4) and Comptroller's Decision No. 41,859 (2003) (When a licensing agreement shows that exclusive rights to the software were not transferred to the customer, the payments for the license are taxable).
- Cf. Tax Code § 151.3185(e) – exempts the sale of a motion picture, video, or audio master by the producer

Franchise Tax

- Cost of Goods Sold
  - What is a "good"? See Tax Code § 171.1012(a)(3)(A)(ii)
  - Who can claim a cost-of-goods-sold deduction? See Tax Code § 171.1012(o)
- Apportionment – 171.103(a)(4)
  - The gross receipts of a taxable entity from its business done in this state include the taxable entity's receipts from…

    (4) the use of a patent, copyright, trademark, franchise, or license in this state…

Franchise Tax

- Effective 1998 – the franchise tax is levied on "the use of a patent, copyright, trademark, or license in this state."
  - Prior, receipts from trademarks, franchises and licenses used in Texas were sourced to the state of legal domicile
  - Bill Analysis – "equalize treatment among these types of similar intangible assets" and "receipts would be sourced to Texas if the assets were used in Texas."
- *TGS-NOPEC Geophysical Co. v. Combs*, 340 S.W.3d 432, 439 (Tex. 2011)

Franchise Tax

- The *TGS-NOPEC* Court determined that the term "license" means licenses that are themselves revenue-producing assets
- Questions from that case –
  - But what is a “license” in the context of the statute?
  - What about intellectual property that could be formally copyrighted, but hasn’t been?

TAX SECTION
State Bar of Texas

October 24, 2016

Internal Revenue Service
CC:PA:LPD:PR (REG-147196-07)
CC:PA:LPD:PR (REG-123854-12)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations for Deferred Compensation Plans of State and Local Governments and Tax-Exempt Entities and the Application of Section 409A to Nonqualified Deferred Compensation Plans

Dear Sirs and Madams:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Internal Revenue Service ("Service") for comments due to issuing proposed rulemaking in both:

(a) Deferred Compensation Plans of State and Local Governments and Tax-Exempt Entities, 81 Federal Register 40548 ("June 22, 2016"); adding proposed regulations under section 457 of the Internal Revenue Code of 1986, as amended ("Section 457" and "Code", respectively); and

(b) Application of Section 409A to Nonqualified Deferred Compensation Plans, 81 Federal Register 40569 (June 22, 2016), as further published by the Internal Revenue Service ("Service") in Internal Revenue Bulletin: 2016-28 (July 11, 2016), adding proposed regulations under section 409A of the Code ("Section 409A") (both proposals are collectively the "Proposed Regulations").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E Colmenero, Chair
State Bar of Texas, Tax Section

472866

COMMENTS ON PROPOSED REGULATIONS ADDRESSING
DEFERRED COMPENSATION PLANS OF
STATE AND LOCAL GOVERNMENTS AND
THE APPLICATION OF SECTION 409A TO
NONQUALIFIED DEFERRED COMPENSATION PLANS

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Donna Lowe. Sarah Fry, Vice Chair of the Committee on Employee Benefits ("CEB") of the Tax Section of the State Bar of Texas also worked on these comments and approved them. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Henry Talavera, Chair of COGS, reviewed these Comments. Russell Gully reviewed the Comments and made substantive suggestions on behalf of COGS. Justin Coddington also reviewed the Comments and provided substantive suggestions.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

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Date: October 24, 2016

472866

These comments are provided in response to the Service's invitation for comments regarding the Proposed Regulations addressing deferred compensation plans of state and local governments and tax-exempt entities and the application of Section 409A nonqualified deferred compensation plans. We appreciate the opportunity to comment on the Proposed Regulations.[1]

We are providing comments on three (3) topics that we respectfully suggest the Service consider clarifying:

1. That an amount included in gross income under Section 457(f) of the Code ("Section 457(f)) when a substantial risk of forfeiture lapses should be exempt from Section 409A for all subsequent taxable years. In addition (or at least alternatively), to the extent such amounts are subject to Section 409A, we suggest that these amounts should be consistently treated as a short-term deferral for purposes of applying the rules of Section 409A and Section 457(f), generally, until the end of the applicable 2½ month period following the taxable year in such amount is included in income.

2. A glitch in Proposed Regulation § 1.409A-1(q) with respect to an amount "paid." At least in one instance we cite below, "paid" appears to be an amount actually distributed from a plan, as opposed to a "payment being made"[2]. Generally, a payment being made includes an amount included in gross income, but we found a situation where use of the term "payment being made" would appear to result in a circular reference.

3. That the Proposed Regulations under Section 457 exempt legal fees, indemnification, legal settlements, and specified educational benefits from the reach of Section 457(f). We suggest that any treatment should be consistent with what is provided under Section 409A regulations so that such payments should not be treated as deferred compensation under either Section 409A or 457(f).

Many tax-exempt entities, generally those exempt from tax under Section 501 of the Code and governmental entities (collectively "tax-exempt entities"), utilize nonqualified deferred compensation arrangements to recruit and retain high level executives, which arrangements are subject to Sections 457 and 409A. The Proposed Regulations bring a welcome consistency to the Section 409A framework by clarifying that these rules apply to Section 457(f) plans in the same manner as other deferred compensation arrangements.

The suggestions we make regarding these Proposed Regulations are intended to further this initiative.

---

[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] Proposed Regulation § 1.409A-1(q)

I. WE SUGGEST THAT THE SERVICE SHOULD CLARIFY THAT AN AMOUNT INCLUDED IN GROSS INCOME IS NO LONGER DEFERRED COMPENSATION AND IS EXEMPT FROM THE REQUIREMENTS OF SECTION 409A FOR ALL SUBSEQUENT TAXABLE YEARS. ALTERNATIVELY, AN AMOUNT INCLUDED IN GROSS INCOME IS A SHORT-TERM DEFERRAL FOR PURPOSES OF APPLYING SECTION 409A.

Compensation under an "ineligible plan" (as defined under applicable Section 457(f) guidance) ("plan") is included in income when the substantial risk of forfeiture lapses, including earnings "thereon to the date on which there is no substantial risk of forfeiture." *See* Treasury Regulations §§ 1.457-11(a)(1), (2) & (c). As a result, many practitioners have taken the position that the amounts included in gross income under such plan are exempt from Section 409A requirements, because such amounts can never be deferred past the date the substantial risk of forfeiture lapses. *See generally* Section 409A(a)(1) (arguably exempts from 409A amounts if a substantial risk of forfeiture lapses and such amounts are then included in gross income). However, the Service has consistently taken the position that Section 409A applies to Section 457(f) arrangements. *See* Notice 2005-1, Q&A 6; Treasury Regulations § 1.409A-1(a)(4) (409A may apply to Section 457(f) arrangements).

Furthermore, there has been uncertainty regarding the application of Section 409A requirements related to elections, distributions, and acceleration as it relates to plans subject to Section 457(f), specifically as it relates to amounts under a plan that become taxable when a substantial risk of forfeiture lapses. We agree that Section 409A may apply to amounts deferred under a plan for which taxation is deferred to a subsequent taxable year. On the other hand, once a substantial risk of forfeiture lapses and an amount is properly included in gross income, such amount is no longer deferred compensation and Section 409A no longer applies to such amount. We respectfully suggest the Service clarify that once an amount is included in gross income (under Treasury Regulations §§ 1.457-11(a)(1) & (2)) in the year in which a substantial risk of forfeiture lapses, such amounts are no longer deferred compensation ever subject to the requirements of Section 409A, regardless of when such amounts are actually distributed from such plan. Any clarification in this regard by the Service would be greatly appreciated.

In addition (or at least alternatively), we suggest that an amount payable from a plan should (to the extent any amounts under such plan are subject to Section 409A) be treated as a short-term deferral if such amount is included in gross income before the end of the 2½ month period after end of the taxable year during which such amount is no longer subject to a substantial risk of forfeiture. Notice 2007-62 and the Preamble to the Proposed Regulations propose a bifurcated application of Section 409A, under which an amount subject to gross income inclusion is a short-term deferral generally exempt from Section 409A, but future earnings on such amount will be deferred compensation for purposes of Section 409A.

We respectfully suggest that the Service clarify that this bifurcated treatment can be avoided if a service provider makes an initial election to defer amounts included in income during the short term deferral period, for the reasons that follow.

The Preamble to the Proposed Regulations provides, in pertinent part, the following:

> There may also be instances in which a portion of an amount payable under an arrangement that is subject to section 457(f) is a short-term deferral for purposes of both section 409A and section 457(f)(1)(A), while another portion of the amount is a deferral of compensation for purposes of section 409A. For example, assume an arrangement subject to section 457(f) provides for payment of a specified dollar amount plus earnings upon separation from service, with vesting to occur when the service provider has completed three years of service. The specified dollar amount plus earnings to date is includible in income under section 457(f)(1)(A) when the service provider completes three years of service, and ***that amount will be a short-term deferral under section 409A*** if the service provider includes it in income at that time. The service provider's right to receive a payment of ***additional earnings accruing after the vesting date is a deferred compensation plan under section 409A***.
>
> (Emphasis added).

Preamble to Proposed Regulations, 81 Federal Register 40574, fn. 2.

Current guidance defines the term "short-term deferral" as an amount "actually or constructively received" before the end of the 2½ month applicable period and describes a "payment" as an amount included in income. *See* Proposed Regulations §§ 1.409A-1(b)(4)(i)(A)-B. The Proposed Regulations revise this current guidance to refer to Proposed Regulation § 1.409A-1(q) to define the triggers that determine both the occurrence of a payment and the timing of that payment. The Preamble to Proposed Regulations further defines when a "payment" occurs, as follows:

> Under these proposed regulations, a payment is made, or the payment of an amount occurs, when any taxable benefit is actually or constructively received. Consistent with the final regulations, these proposed regulations provide that a payment includes a transfer of cash, any event that results in the inclusion of an amount in income under the economic benefit doctrine, a transfer of property includible in income under section 83, a contribution to a trust described in section 402(b) at the time includible in income under section 402(b), and the transfer or creation of a beneficial interest in a section 402(b) trust at the time includible in income under section 402(b). In addition, a payment is made upon the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare plan or a non-taxable fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income.

See also Proposed Regulation § 1.409A-1(q) (essentially incorporating the language cited above).

These Proposed Regulations provide that inclusion in gross income pursuant to a taxable event described in Proposed Regulation § 1.409A-1(q) results in such taxable amount becoming a short-term deferral for purposes of Section 409A. This conclusion is consistent with Notice 2007-62. *See also* Proposed Regulation § 1.409A-2(b)(2)(i) (also defining "payment" under Section 409A by adding a cross-reference to Proposed Regulation § 1.409A-1(q) to determine when a payment occurs).

The triggering tax event for both of these provisions is described in Proposed Regulation § 1.409A-1(q), which provides in relevant part:

> A payment is made or an amount is paid or received when any taxable benefit is actually or constructively received, which includes a transfer of cash, a transfer of property includible in income under section 83, any other event that results in the inclusion in income under the economic benefit doctrine, a contribution to a trust described in section 402(b) at the time includible in income under section 402(b), a transfer or creation of a beneficial interest in a section 402(b) trust at the time includible in income under section 402(b), and the inclusion of an amount in income under [section] 457(f)(1)(A).
>
> (*Language in brackets added*).

This linkage is a welcome addition that enhances consistency of the Section 409A framework. In light of this linkage, any amount subject to income inclusion (and actually included in gross income by a taxpayer) and not entirely exempted from the requirements of Section 409A, should arguably be a "short-term deferral" for all purposes of applying the rules of Section 409A.

We respectfully suggest that if the Service determines the requirements of Section 409A apply to an amount previously included in gross income, the Service consider clarifying that gross income inclusion results in characterization of an amount as a short-term deferral for purposes of applying Section 409A during the entire short-term deferral period, regardless of when such amounts would otherwise be payable from the plan. Specifically, we respectfully suggest that, as a short-term deferral, an amount included in income under Section 457(f), or otherwise, should not be subject to the applicable requirements of Section 409A before the end of the 2½ month period following the end of the taxable year for which the short-term deferral amount is included in gross income.

We also suggest that the Service both (a) acknowledge that immediate distribution of an amount included in gross income is not a prohibited acceleration of deferred compensation, and (b) permit a specific initial election described in Treasury Regulation § 1.409A-2(a)(4) within such short-term deferral period to allow deferral of actual distribution from the plan.

First, we suggest that amounts otherwise distributable under a plan outside of the short-term deferral period could be immediately distributed within the short-term deferral period without running afoul of Section 409A's prohibition of acceleration, but only with respect to amounts subject to taxation/income inclusion during the short-term deferral period. Once the amount is included in gross income, we suggest that those amounts are no longer deferred compensation, regardless of when such amounts are actually distributed from the plan, although future earnings associated with those amounts may (as we note above) be deferred compensation subject to Section 409A.

For example, if amounts under a plan vest in year three (3), but are payable in year six (6), a tax-exempt sponsor should be able to immediately distribute all the amounts vesting in year three (3) during the short-term deferral period, because taxes have been paid on such amounts. Any flexibility and clarification in this regard by the Service would be greatly appreciated.

Next, we suggest that a service provider should be permitted to either receive a distribution or make an initial election as described in Treasury Regulation § 1.409A-2(a)(4) with respect to the amounts included in income during the short-term deferral period consistent with the general requirements regarding elections in Section 409A.

Treasury Regulation § 1.409A-2(a)(4) provides, in pertinent part:

> (4) Initial deferral election with respect to short-term deferrals. If a service provider has a legally binding right to a payment of compensation in a subsequent taxable year that, absent a deferral election, would be treated as a short-term deferral within the meaning of §1.409A–1(b)(4), an election to defer such compensation may be made in accordance with the requirements of paragraph (b) of this section, applied ***as if the amount were a deferral of compensation and the scheduled payment date for the amount were the date the substantial risk of forfeiture lapses.*** Notwithstanding the requirements of paragraph (b) of this section, such a deferral election may provide that the deferred amounts will be payable upon a change in control event (as defined in §1.409A–3(i)(5)) without regard to the five-year additional deferral requirement in paragraph (b) of this section.

(*Emphasis added*).

Based upon the highlighted language above, it appears that a timely and proper deferral election applicable to a short-term deferral would treat the amount "as if" such amounts were generally subject to a substantial risk of forfeiture that lapses on the elected distribution date. As a result, we suggest the Service consider clarifying the Proposed Regulations to provide that a short-term deferral amount (along with associated earnings included in gross income during the short-term deferral period under the terms of the plan) retains its status as a short-term deferral until the end of the applicable 2½ month period after a substantial risk of forfeiture lapses. *See* Section 409A(4)(B) (the Service may permit deferral elections as may be provided in regulations; we are asking the Service to exercise this discretion). Further, a service provider may either receive a distribution of the short-term deferral amount (including earnings taxed during this period) or make an initial election described in Treasury Regulation § 1.409A-2(a)(4) at any time prior to the end of the applicable 2½ month period.

472866

We also respectfully suggest that the Proposed Regulations be modified to confirm that if a service provider makes a timely initial election to defer a short-term deferral amount (including any associated earnings taxed during the short-term deferral period), any subsequent elections related to this amount are subject to the modified subsequent election parameters provided by Treasury Regulation § 1.409A-2(a)(4), but would otherwise conform to the requirements of Section 409A.

For purposes of consistency, we also respectfully suggest that if a delayed distribution of a short-term deferral is permitted because of impracticability or illegality pursuant to Treasury Regulation § 1.409A-2(b)(4)(ii), as revised in the Proposed Regulations, the opportunity to make a valid initial election should remain open for such period.

If the Service determines that the requirements of Section 409A continue to apply to an amount after it is included in gross income and a service provider does not make a timely initial election with respect to an amount that is a short-term deferral, the taxation of future earnings would still be subject to the rules otherwise applicable to the deferred compensation plan. Any earnings accrued on this amount in excess of the amount included in gross income (or which are not distributed during the short-term deferral period) should be deferred compensation subject to Section 409A as provided in Notice 2007-62 and the Preamble cited above.

In accordance with this approach, we suggest that the Service should revise the Example provided in Proposed Regulation § 1.457-12(d)(5) and the corresponding provision to be included in Treasury Regulation § 1.409A-4 to clarify that an amount included in gross income is also a short-term deferral.

We respectfully suggest that Proposed Regulation § 1.457-12(d)(5)(ii), and when finalized, the corresponding provision of Proposed Regulation § 1.409A-4 could be amended to read as follows:

> (ii) Conclusion: Federal income tax treatment in 2021. The plan provides for a deferral of compensation to which section 457(f) applies. Under section 457(f) and paragraph (a)(2) of this section, the $100,000 amount of the account balance on December 1, 2021, when the benefits cease to be subject to a substantial risk of forfeiture, is included in the employee's gross income on that date. <u>For purposes of applying the rules of section 409A, this amount is a short-term deferral for the period from December 1, 2021 through March 15, 2022 (unless this period is extended pursuant to § 1.409A-1(b)(4)). During this period, the service provider may receive a distribution or make an initial election to defer this amount pursuant to § 1.409A-2(a)(4). Additionally, a deferred compensation plan may provide for acceleration and allow a distribution of a short-term deferral during this period for any amounts that might otherwise be deferred compensation distributable in a subsequent tax year, but are short-term deferrals because the present value of such amounts has been included in gross income by the service provider.</u>

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II. WE SUGGEST THAT THE SERVICE SHOULD, IN CERTAIN CONTEXTS, PRESERVE THE DISTINCTION BETWEEN AMOUNTS DISTRIBUTED FROM A PLAN AND AMOUNTS INCLUDED IN GROSS INCOME, BUT RETAINED IN THE PLAN.

The Proposed Regulations provide that references to a "payment being made" from a plan include a variety of tax events that may or may not reduce the amount of benefits owed to a service provider. *See* Proposed Regulations § 1.409A-1(q) (describing references to a "payment being made.") While we understand and agree that the intent of Section 409A is to treat amounts subject to these taxable events consistently, we suggest that the Service distinguish between actual distributions versus amounts subject to income inclusion but retained in a deferred compensation plan.

A brief example highlights the issue. Proposed Regulation § 1.409A-4(a)(3) provides, in relevant part, the following:

> "For future taxable years, the amount previously included in income is reduced to reflect any amount that was ***paid*** during the taxable year for which the amount was included in income, any amount allocated to a payment made under the plan under paragraph (f) of this section, and any amount deductible under paragraph (g) of this section."
> (Emphasis added).

In this instance the term "paid" appears to refer only to the amount actually distributed in a taxable year and requires this amount to be subtracted from amounts previously "included in income," but retained in, and not distributed from, the deferred compensation plan. Otherwise, this provision could be read as having income included, and then reduced by amounts included income (i.e., "paid" as defined under the Proposed Regulations) during the year "in which amount was included in income." We respectfully suggest that this sentence loses its meaning with this construction, and this may lead to confusion in applying the Proposed Regulations. We did not check all of the current guidance and Proposed Regulations for similar inconsistencies, but since there are numerous uses of these terms, additional inconsistencies are likely to occur.

To avoid confusion, we respectfully suggest the Service consider distinguishing, as needed, between amounts "paid" as either "paid and distributed" or "paid and retained" (or similar), with respect to a deferred compensation plan, along with perhaps adding the following sentences to Proposed Regulation § 1.409A-1(q), as follows:

> The term "paid" as used in this section may refer to any payment being made, or alternatively, simply may refer to an actual distribution, as the context requires. If a service provider includes an amount in gross income and does not actually receive the amount as a distribution from a deferred compensation plan, this amount may also be referenced as an amount paid and retained by the plan (or constructively received).

Nonetheless, we do appreciate that the Service generally treats deferred compensation amounts subject to gross income inclusion the same as any other amount actually distributed from a plan.

III. WE SUGGEST THAT THE SERVICE CLARIFY THAT INDEMNIFICATION, LEGAL SETTLEMENT AND CERTAIN EDUCATIONAL BENEFITS ARE NOT SUBJECT TO SECTION 457(F).

Treasury Regulations §§ 1.409A-1(b)(10) through (12) provide the circumstances under which payments related to indemnification, legal settlements, and certain educational benefits are not deferred compensation for purposes of Section 409A. We suggest that the Service consider providing parallel guidance under Section 457(f), as this issue has raised concerns with at least some practitioners. *See generally* Ropes & Gray, Game On! Recent Legal Developments and Tax Issues for Collegiate Athletics (September 14, 2014), *found at* https://www.ropesgray.com/newsroom/alerts/2014/September/Game-On-Recent-Legal-Developments-and-Tax-Issues-for-Collegiate-Athletics.aspx (Raising the concern that a court-ordered settlement [from not-for-profit and/or governmental institutions] would constitute deferred compensation under Section 457(f)).

Proposed Regulation § 1.409A-1(b)(11) clarifies that payment of legal fees associated with litigation between a service provider and service recipient is not deferred compensation for purposes of Section 409A. We respectfully suggest the Service consider providing additional consistency under Section 457 by applying the same treatment to all of payments described in Treasury Regulations § 1.409A-1(b)(10) through (12) related to indemnification, litigation settlements, and specified education expenses. To provide this consistency, we respectfully suggest the Service finalize the proposed revision to Proposed Regulation § 1.409A-1(b)(11) and consider issuing guidance under Section 457 that parallels Proposed Regulation § 1.409A-1(b)(10) through (12) as part of the final Section 457(f) regulations. We respectfully request that the Service expressly provide that any such payments are not deferred compensation subject to the reach of Section 457 (and Section 457(f) in particular).

TAX SECTION
State Bar of Texas

November 2, 2016

Via Federal eRulemaking Portal at www.regulations.gov

CC:PA:LPD:PR (REG-163113-02)
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations Regarding Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") in the Notice of Proposed Rulemaking (REG-163113-02) issued on August 4, 2016 (the "Proposed Regulations"). The Proposed Regulations provide rules concerning the valuation of interests in certain business entities for estate, gift, and generation-skipping transfer tax purposes, specifically including the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in corporations, partnerships, and other entities.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS.

THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the IRS for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED REGULATIONS REGARDING ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES; RESTRICTIONS ON LIQUIDATION OF AN INTEREST

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Matthew S. Beard, Vice-Chair of the Estate and Gift Tax Committee, and Carol Warley, Vice-Chair of the Estate and Gift Tax Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Ira. A. Lipstet, Co-Chair of COGS, reviewed these Comments. Lora G. Davis, a current member of the Tax Section Council, and Melissa Willms, a former member of the Tax Section Council, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 2, 2016

I. INTRODUCTION

These Comments are in response to the Proposed Regulations regarding the rules concerning the valuation of interests in certain business entities for estate, gift, and generation-skipping transfer tax purposes, specifically with respect to the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in corporations, partnerships, and other entities.

We recognize the time and thoughtful work invested by Treasury and the IRS in preparing the Proposed Regulations and the accompanying explanatory preamble to the Proposed Regulations (the "Preamble"). It is our intent to present items for consideration that may help support Treasury and the IRS to provide clear regulatory guidance.

For ease of discussion, we have opted to address our concerns with regard to the Proposed Regulations in a limited partnership context. However, we have identical concerns with regard to the application of the Proposed Regulations in corresponding corporate and limited liability company contexts.

II. COMMENTS REGARDING PROPOSED REGULATIONS UNDER CODE[1] § 2704

A. Interaction of Proposed Regulations with Code § 1014(f)

Code § 1014(f) provides that the initial basis of certain property acquired from a decedent "shall not exceed" its final value determined for estate tax purposes (or as otherwise reflected on Schedule(s) A to an IRS Form 8971). However, the Proposed Regulations expressly apply only "for purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes)" and not for income tax purposes. Technically, it appears that the IRS could argue pursuant to Code § 1014(a) that an interest acquired from a decedent in an entity described in Code § 2704 should have an initial income tax basis equal to its fair market value as of the decedent's date of death and not the estate tax value resulting from disregarding, pursuant to Code § 2704 and the Proposed Regulations, lapsing rights and liquidation restrictions that are otherwise relevant in establishing the interest's fair market value.

We believe the IRS and Treasury have no intention of taking this position, given that they clearly state in the preamble to Prop. Reg. § 1.1014-10 that Code § 1014(f) is intended to ensure consistency between the income tax basis of property acquired from a decedent and its estate tax value. Accordingly, we respectfully request the IRS and Treasury clarify that lapsing rights and liquidation restrictions disregarded pursuant to Code § 2704 and the Proposed Regulations for establishing the estate tax value of an interest acquired from a decedent in an entity described in Code § 2704 are also to be disregarded in establishing its income tax basis so that its initial basis

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[1] All references herein to the "Code §" or "Section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "Prop. Reg. §" are to the current and the proposed regulations promulgated thereunder, respectively.

will be equivalent to its final value determined for estate tax purposes (or as otherwise reflected in a Form 8971 and accompanying Schedule A).

We recognize that the suggested clarification may be more appropriate in conjunction with Prop. Reg. § 1.1014-10, particularly in light of an arguably similar need for clarity with regard to the impact of Code § 2703 and its regulations on the valuation, for both estate tax and income tax basis purposes, of entity interests transferred by a decedent. Consequently, we respectively request clarification and defer to the IRS in determining the manner in which this clarification may be best addressed.

B. Three-Year "Inclusion Window" Provided by Prop. Reg. § 25.2704-1(c)(1)

1. Recommended Alternative to Proposed Three-Year Inclusion Window

Currently, Treas. Reg. § 25.2704-1(c)(1) provides an exception to Code § 2704(a) for a transfer of an interest in an entity that results in a lapse of a liquidation right, as long as the rights associated with the transferred interest are not restricted or eliminated, although the transferor's loss of an ability to compel the entity to acquire a retained subordinate interest will be treated as a lapse with regard to it (the "Current Exception"). Prop. Reg. § 25.2704-1(c)(1) narrows the Current Exception to apply only to a transfer "occurring" more than three years prior to the transferor's death but also expands the exception to cover a lapse of a voting right associated with such a transfer (the "Proposed Narrowed Exception"). Conversely, a lapse of a voting or liquidation right resulting from a transfer within three years of the transferor's death will be treated as a lapse occurring at the transferor's death, includible in the transferor's gross estate pursuant to Code § 2704(a). These changes result in a potential three-year "inclusion window."

We do not believe that an inclusion window is appropriate. However, we believe that if one is to be adopted, it should more precisely address the concerns with "deathbed" transfers noted by the IRS and Treasury in the Preamble. We understand the practical benefits of incorporating a bright-line test to address the perceived abuses of deathbed transfers that are motivated solely by a desire to avoid inclusion of a controlling interest in a family entity in the transferor's estate for estate tax purposes. However, a strict application of the proposed three-year inclusion window will invariably produce a punitive tax result for a transferor who dies unexpectedly after transferring an entity interest without any "deathbed" motivations.

We propose instead that a lapse of a voting or liquidation right resulting from a gift be treated as occurring at the transferor's death only if he or she was "terminally ill" at the time of the gift, as determined in accordance with Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), and 25.7520-3(b)(3). Admittedly, an adoption of the "terminally ill" test will not provide in many instances the bright-line result otherwise achievable with the proposed three-year inclusion window. However, the "terminally ill" standard provides a workable and balanced approach to addressing the IRS's and Treasury's concerns with abusive deathbed transfers while avoiding penalizing transferors who are engaging in lifetime planning without deathbed objectives but die unexpectedly within a relatively short time thereafter.

2. Recommended Clarity on Effective Date of Three-Year Inclusion Window, if Retained

Prop. Reg. § 25.2704-4(b)(1) provides that Prop. Reg. § 25.2704-1(c)(1) will only apply to lapses of rights created after October 8, 1990 occurring on or after the date the Proposed Regulations are published as final in the Federal Register (the "Effective Date"). If despite our recommendation the three-year inclusion window is retained, it is unclear how Prop. Reg. § 25.2704-1(c)(1) will apply if an interest is transferred prior to the Effective Date but the transferor dies after the Effective Date and within three years of the transfer. Arguably, a lapse otherwise ignored at the time of the transfer prior to the Effective Date could ultimately be deemed to have occurred upon the transferor's death after the Effective Date, causing the value of the asset attributable to the lapse to be included in the transferor's estate for estate tax purposes.

Treasury and the IRS have historically provided effective dates for proposed regulations based in part upon their appreciation of planners' duties to their clients and the need to counsel them on the risks associated with different planning techniques based upon laws in effect at the time those techniques are implemented. We accordingly believe Prop. Reg. § 25.2704-1(c)(1) is intended to apply solely to lapses of voting or liquidation rights associated with lapses actually occurring after the Effective Date. If that belief is correct, then we propose that the last sentence of Prop. Reg. § 25.2704-1(c)(1) be revised to include the underlined text as follows: "The lapse of a voting or liquidation right as a result of the transfer of an interest after the Effective Date set forth in § 25.2704-4(b)(1) and within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)."

3. Recommended Clarity on Valuation of Lapse Deemed to Occur at Death

We would also appreciate guidance with regard to the valuation of the voting or liquidation right deemed to have lapsed on the transferor's death pursuant to Prop. Reg. § 25.2704-1(c)(1) (the "phantom asset"). The Preamble makes it clear that Prop. Reg. § 25.2704-1(c)(1) is intended to address "deathbed" transfers designed to avoid estate taxation of a controlling interest. Given that objective, it appears that inclusion of the value of the phantom asset in the transferor's estate is intended to recapture the discounts otherwise properly applied in valuing both the retained interest and the transferred interest. Based upon this premise, it seems that the phantom asset is properly valued as the excess of (i) the value (as of the decedent's date of death) of the transferred and retained interests (both deemed owned at that point by the decedent), determined as though the liquidation and/or voting rights were non-lapsing over (ii) the value (as of the decedent's date of death) of the transferred and retained interests immediately after the lapse(s) that is deemed to have occurred, with the transferred and retained interests valued as though they were includible in the decedent's gross estate for estate tax purposes, but not aggregated for purposes of determining the value of each interest. We would appreciate regulatory guidance confirming that this is the proper approach for valuing the "phantom asset."

We would also appreciate guidance with regard to the manner in which the "applicable restriction" and "disregarded restriction" rules will be applied, or not applied, in the event that Prop. Reg. § 25.2704-1(c)(1) requires the inclusion of the "phantom asset," so that a double taxation of value is avoided.

C. Determination of Minimum Value

1. Recommended Determination if Entity Holds Operating Business or Other Illiquid Assets

We would appreciate clarity with regard to the manner in which the "minimum value" for an interest in a family-controlled entity is to be determined in certain circumstances. Prop. Reg. § 25.2704-3(b)(ii) defines "minimum value" as an interest's share of the entity's net value as of the date of liquidation or redemption. As a general rule, an entity's net value will be equal to the fair market value of its property reduced by its outstanding obligations that would meet the deductibility standard of Code § 2053 if they were claims against an estate (a "Net Asset Value"). If an entity holds an operating business, Prop. Reg. § 25.2704-3(b)(ii) directs that its net value may be appropriately determined by also considering additional factors such as prospective earning capacity, dividend-paying capacity, and goodwill.

An interest's minimum value is effectively calculated based upon its holder's deemed ownership of a proportionate share of the entity's underlying assets (if assigned a Net Asset Value) or its operating business (if appropriately valued by consideration of the expanded list of factors). Given that, we request that if an interest's minimum value is in part derived from a proportionate share of an illiquid interest owned by an entity (e.g., real estate or an operating business) then that interest's value is to be determined by also taking into consideration any valuation discounts that would be appropriately considered in valuing an undivided interest held directly in such an illiquid interest.

For an example of why this proposed modification is suggested, assume that family members A, B, C, and D each own outright a 25% fractional interest in real property with a fair market value of $1,000,000. By its very nature, the interest each of A, B, C, and D owns in the real property is not worth $250,000. Instead, the value of each person's interest should take into account discounts for lack of control and lack of marketability and consequently be valued at some amount less than $250,000.

Further assume that A, B, C, and D transfer their interests in the real property to an entity, resulting in the entity owning the real property in its entirety. Thus, the minimum value of each individual's interest in the entity is $250,000, or $1,000,000 (the property's fair market value) multiplied by 25% (each individual's interest in the property). Pursuant to Prop. Reg. § 25.2704-3(b)(1)(ii), the minimum value of each person's interest is deemed to be $250,000 upon contribution of the property to the entity. We believe that the Proposed Regulations in this regard unduly penalize for transfer tax purposes individuals who include restrictions in business arrangements to secure creditor protections and other nontax benefits provided by owning real estate and operating businesses via an entity rather than co-owning those assets directly.

Thus, we respectfully request that Treasury and the IRS revise the Proposed Regulations to provide a look-through rule in the following suggested new last sentence to Prop. Reg. § 25.2704-3(b)(1)(ii): "Notwithstanding the preceding, if the entity holds an operating business, real estate, or other property with regard to which the value of an interest therein would typically be affected by the degree of control of such business or property that interest represents (an "Illiquid Asset"), then the "minimum value" of an interest in such entity shall be equal to (i) the fair market value, as of the date of liquidation or redemption, of such interest's share of the property held by the entity (as determined pursuant to section 2031 or 2512 and the applicable regulations), provided that any value attributable to such interest's share of an Illiquid Asset shall be determined by taking into consideration any discounts that would otherwise be appropriately applied in establishing the value of an undivided interest in such Illiquid Asset if it were held directly by an individual, reduced by (ii) such interest's proportionate share of the outstanding obligations of the entity meeting the criteria set forth above, if the net value of the entity is determined based upon its Net Asset Value."

2. Requested Clarity in Establishing Minimum Value of Interest in a Parent Entity Holding an Interest in a Subsidiary with an Operating Business

The Proposed Regulations are unclear regarding the appropriate method of valuing an operating business for purposes of determining minimum value in certain circumstances. The Preamble states that for purposes of determining minimum value, "if the entity holds an operating business, the rules of §20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer." Those provisions direct that the valuation of an interest in an operating business involves more than simply valuing its assets and netting its obligations against the total asset value. It requires consideration of factors such as its prospective earning capacity, dividend-paying capacity, and goodwill. It is unclear whether those valuation rules are to be applied only when a parent entity conducts an operating business or whether they also apply in determining the value of a parent entity's interest in a subsidiary entity that conducts an operating business.

The Preamble and Prop. Reg. § 25.2704-3(b)(ii) initially seem to suggest that for purposes of determining minimum value, the fair market value of an operating business held via a subsidiary should be valued by considering the expanded list of factors for consideration outlined in Treas. Reg. §§ 20.2031-2(f)(2), 20.2031-3, 25.2512-2(f)(2) and 25.2512-3. However, the last sentence of Prop. Reg. § 25.2704-3(b)(ii) provides that if the property held by the entity directly or indirectly includes an interest in another entity (which could be an operating business) with regard to which transfers by the transferor would trigger an application of Code § 2704(b), the parent entity will be treated as owning a share of the property held by the other entity "determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder." It is therefore not entirely clear if the minimum value of a parent entity's interest in an operating business held via a subsidiary entity should be based strictly on the value of the operating business's underlying property in accordance with the last sentence of Prop. Reg. § 25.2704-3(b)(ii) or whether its value should be determined after valuing the subsidiary based upon a consideration of the expanded list of additional factors referred to above.

We respectfully request that Treasury and the IRS clarify which of the preceding interpretations is the intended result under the Proposed Regulations and provide examples that would clearly identify how minimum value should be determined with respect to operating businesses held by a family-controlled entity via a subsidiary entity.

D. Recommended Clarity on Existence of "Put Right"

We appreciate the assurances provided by representatives of Treasury and the IRS that the Proposed Regulations are not to be interpreted as imputing a "put right" to holders of interests in family-controlled entities and welcome a clarification in that regard in the final regulations. If correctly understood, the assurances alleviate our prior concern that a transfer of an interest that results in a lapse of a liquidation right could cause the gifted and retained interests' liquidation values to be taxed twice via an application of the "disregarded restriction" rules and the rules of Prop. Reg. § 25.2704-1(c)(1) that would be applicable if the transfer does not qualify for the Proposed Narrowed Exception. We respectfully request that clarification of this issue be included in any revised regulatory guidance that is released.

E. Requested Clarity Regarding Individuals Required to "Control" Entity for Purposes of Prop. Reg. §§ 25.2704-2 and 25.2704-3

Each of Prop. Reg. §§ 25.2704-2 and 25.2704-3 provides that it applies only if "the transferor and/or members of the transferor's family" control an entity immediately prior to a transfer of an interest in it. Each Proposed Regulation directs that "member of the family" be defined by Treas. Reg. § 25.2702-2(a)(1), which defines that term to include the transferor's spouse, ancestors and descendants of either the transferor or the transferor's spouse, the transferor's siblings, and spouses of the foregoing. Code § 2704(c)(2) provides an identical definition for "member of the family."

<u>Existing</u> Treas. Reg. § 25.2704-2 references Treas. Reg. § 25.2701-2(b)(5) as providing the definition for the term "control." However, Prop. Reg. §§ 25.2704-2 and 25.2704-3 reference Treas. Reg. § 25.2701-2(b)(5) (also modified pursuant to the Proposed Regulations) as providing the definition of the term "controlled entity" but do not direct that it or any other regulation define the term "control." Curiously, "controlled entity" does not appear to be a term of consequence in either of those Proposed Regulations, although each uses the term "family-controlled entities" in a seemingly descriptive manner and not as a term with any apparent technical significance. The reference to Treas. Reg. § 25.2701-2(b)(5) in each of Prop. Reg. §§ 25.2704-2 and 25.2704-3 for a definition of "controlled entity" and not simply "control" has created confusion as to the individuals who are required to possess control of an entity in order for transfers of interests in it to be subject to Code § 2704(b).

The confusion stems from the two-part manner in which Prop. Reg. § 25.2701-2(b)(5) defines "controlled entity." It outlines the type and level of interests for determining "control" of each type of entity. However, in Treas. Reg. § 25.2701-2(b)(5)(i), it also lists the <u>individuals</u> whose ownership of those interests "count" for purposes of characterizing an entity as a "controlled entity," and those individuals are <u>not</u> identical to those defined as "members of the transferor's family." For determining what constitutes a controlled entity, "applicable family members" must be considered. Specifically, spouses of the transferor's descendants are "members of the transferor's family," but any interests they hold in an entity do not "count" in determining whether it is a "controlled entity" for purposes of Code § 2701. Conversely, neither (i) descendants of the transferor's siblings nor (ii) siblings or descendants of siblings of the transferor's spouse are to be considered "members of the transferor's family" but any interests they hold in an entity do "count" in determining whether it is a "controlled entity" because they are applicable family members.

We believe that the individuals who are required to hold control of an entity in order for transfers of interests in it to be subject to Code § 2704(b) are solely those referenced in the definition of "member of the family." We believe that any attempt by the Treasury and the IRS to expand that list of individuals to include those additional individuals referenced in the definition of "controlled entity" would be an inappropriate exercise of the authority provided to them pursuant to Code § 2704(b)(4) to issue the Proposed Regulations. If Treas. Reg. § 25.2702-2(a)(1) is confirmed as providing the appropriate listing of those individuals, then we propose that the first sentence of each of Prop. Reg. § 25.2704-2(c) and Prop. Reg. § 25.2704-3(c) be revised to read: "For the definition of control, see § 25.2701-2(b)(5)(ii), (iii), or (iv), as applicable."

F. Requested Clarity Regarding Apparent Broadening of Family Attribution Principles

Code § 2704(b)(3)(B) (the "Exception") provides that the term "applicable restriction" shall not include any restriction imposed, or required to be imposed, by federal or state law. Treas. Reg. § 25.2704-2(b) currently provides that an applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally in the absence of the restriction. Thus, Treasury and the IRS have interpreted the word "imposed" to refer to the default provisions of state law applicable in the absence of a contrary provision in an entity's governing instrument.

However, Treasury and the IRS have now proposed a narrower interpretation of the Exception in Prop. Reg. § 25.2704-2(b)(4)(ii) (for applicable restrictions) and § 25.2704-3(b)(5)(iii) (for "disregarded restrictions"). Together, those sections direct that a provision of state or federal law that may be overridden in the partnership agreement or otherwise superseded (whether by the partners or otherwise) is not a restriction that is "imposed or required to be imposed by federal or state law." As explained in the Preamble, Treasury and the IRS feel this narrower interpretation is now appropriate because the "current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws" that may on their face substantiate the need for valuation discounts but in Treasury's and the IRS's estimation are likely to be circumvented by the other partners' willingness to accommodate a family member's request that those restrictions be removed.

Effectively, Treasury and the IRS now seem to interpret "impose" as a reference to a non-waivable state or federal restriction, which begs the question of what is to be considered a restriction "required to be imposed" by state or federal law. Some practitioners have speculated that this second prong of the Exception may refer to a state or federal law requiring the actual incorporation in the partnership agreement of a specific restriction on a limited partner's withdrawal right or the right of a limited partnership to liquidate.

We are unaware of any state law provision restricting a limited partner's withdrawal right or the right of a limited partnership to liquidate that cannot be overridden in the partnership agreement. We are also unaware of any state or federal law that requires such a non-waivable provision be incorporated in a partnership agreement. Thus, it seems unlikely that any restriction in a partnership agreement on a limited partner's withdrawal right or the right of a limited partnership to liquidate will qualify for the Exception, as interpreted in the Proposed Regulations. We are concerned that Treasury and the IRS have consequently narrowed the Exception to the extent it will have little or no effect and thus will have been rendered meaningless, which suggests that the Treasury and the IRS have exceeded their Congressional authority in adopting this interpretation. The Proposed Regulations appear to have broadened the application of family attribution principles beyond the few instances in which Congress intended that it be assumed that family members will unite to disregard actual lapses of voting or liquidation rights or restrictions on an entity's liquidation to substantiate an artificially higher value for a transferred (or deemed transferred) limited partnership interest than would otherwise apply.

Congress indicated in the legislative history to Chapter 14 its awareness of the courts' refusal to consider familial relationships among co-owners in valuing transferred interests in family entities and its intent that Chapter 14 not affect discounts available under then present law. 136 Cong. Rec. 15679, 15681 (October 18, 1990); H. Conf. Rept. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606. We believe this effective invalidation of the Exception and corresponding expansion of family attribution principles conflicts with Congress's intent in enacting Chapter 14 and case law of continuing precedential value and may only be undertaken by Treasury and the IRS pursuant to an explicit Congressional directive.

In light of the foregoing, we respectfully suggest that Treasury and the IRS revise Prop. Reg. §§ 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii) to retain the "no more restrictive standard" set forth in § 25.2704-2(b) of the current regulations. Alternatively, if the Treasury and the IRS will not return to the standard of the current regulations, we respectfully request that Treasury add additional examples to the Proposed Regulations that illustrate circumstances under which the Exception will have effect under the new standard contained in Prop. Reg. §§ 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii).

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.

TAX SECTION
State Bar of Texas

November 2, 2016

Via Federal eRulemaking Portal at www.regulations.gov

CC:PA:LPD:PR (REG–163113–02)
Internal Revenue Service
Room 5205
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: REG–163113–02

Dear Ladies and Gentlemen:

On behalf of the State Bar of Texas Tax Section (the "Section"), we respectfully submit the enclosed summary of comments we anticipate will be discussed at the public hearing scheduled for December 1, 2016. Celeste Lawton and Laurel Stephenson will testify at the public hearing as representatives of the Section.

The comments are being presented on behalf of Section. The comments should not be construed as representing the position of the Board of Directors, the Executive Committee or the general membership of the State Bar of Texas. The comments are being made subsequent to approval of the Committee on Government Submissions of the Section and pursuant to the procedures of the Section Council (the governing body of the Section). No approval or disapproval of the general membership of the Section has been obtained and the comments represent only the views of the members of the Section who prepared them.

Respectfully submitted,

Ira Lipstet
Co-Chair, Committee on Government Submissions
State Bar of Texas, Tax Section

Discussion Topics for Public Hearing on Proposed Regulations Regarding Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest [REG–163113–02]

The State Bar of Texas Tax Section (the "Section") has not taken a formal position concerning the proposed regulations. However, the Section, through its representatives, Celeste Lawton and Laurel Stephenson, desires to serve as a resource and to testify at the public hearing in response to the request of the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS"). Following are summaries of topics anticipated to be addressed at the December 1, 2016 public hearing.

I. Interaction of Proposed Regulations with Code § 1014(f)

We believe lapsing rights and liquidation restrictions disregarded pursuant to Code § 2704 and the Proposed Regulations for establishing the estate tax value of an interest acquired from a decedent in an entity described in Code § 2704 are also to be disregarded in establishing its income tax basis so that its initial basis will be equivalent to its final value determined for estate tax purposes (or as otherwise reflected in a Form 8971 and accompanying Schedule A).

II. Three-Year "Inclusion Window" Provided by Prop. Reg. § 25.2704-1(c)(1)

A. Recommended Alternative to Proposed Three-Year Inclusion Window

We believe the three-year "inclusion window" specified pursuant to Prop. Reg. § 25.2704-1(c)(1) is inappropriate and that its application should be reconsidered. We will also testify that if an "inclusion window" is to be adopted it should more precisely address the concerns with "deathbed" transfers noted by the IRS and Treasury in the Preamble. We will propose in that regard that a lapse of a voting or liquidation right resulting from a gift be treated as occurring at the transferor's death only if he or she was "terminally ill" at the time of the gift, as determined in accordance with Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), and 25.7520-3(b)(3).

B. Recommended Clarity on Effective Date of Three-Year Inclusion Window, if Retained

Clarification is needed regarding the application of Prop. Reg. § 25.2704-1(c)(1) (if retained) in the event that an interest is transferred prior to the Effective Date of the Proposed Regulations (the "Effective Date") but the transferor dies after the Effective Date and within three years of the transfer. We believe Prop. Reg. § 25.2704-1(c)(1) is intended to apply solely to lapses of voting or liquidation rights associated with lapses <u>actually</u> occurring after the Effective Date and will suggest a clarification along those lines.

C. Recommended Clarity on Valuation of Lapse Deemed to Occur at Death

Clarification is needed regarding valuation of a voting or liquidation right deemed to have lapsed on the transferor's death pursuant to Prop. Reg. § 25.2704-1(c)(1). Our view is that it should be valued as the excess of (i) the value (as of the decedent's date of death) of the transferred and retained interests (both deemed owned at that point by the decedent), determined as though the liquidation and/or voting rights were non-lapsing over (ii) the value (as of the decedent's date of death) of the transferred and retained interests immediately after the lapse(s) that is deemed to have occurred, with the transferred and retained interests valued as though they were includible in the decedent's gross estate for estate tax purposes, but not aggregated for purposes of determining the value of each interest.

We will also discuss the need for clarity regarding the manner in which the "applicable restriction" and "disregarded restriction" rules will or will not be applied, in the event that Prop. Reg. § 25.2704-1(c)(1) requires the inclusion of the "phantom asset," so as to avoid a double taxation of value.

III. Determination of Minimum Value

A. Recommended Determination if Entity Holds Operating Business or Other Illiquid Assets

We will recommend revision of the Proposed Regulations to provide a look-through rule by way of adding the following suggested new last sentence to Prop. Reg. § 25.2704-3(b)(1)(ii):

> Notwithstanding the preceding, if the entity holds an operating business, real estate, or other property with regard to which the value of an interest therein would typically be affected by the degree of control of such business or property that interest represents (an "Illiquid Asset"), then the "minimum value" of an interest in such entity shall be equal to (i) the fair market value, as of the date of liquidation or redemption, of such interest's share of the property held by the entity (as determined pursuant to section 2031 or 2512 and the applicable regulations), provided that any value attributable to such interest's share of an Illiquid Asset shall be determined by taking into consideration any discounts that would otherwise be appropriately applied in establishing the value of an undivided interest in such Illiquid Asset if it were held directly by an individual, reduced by (ii) such interest's proportionate share of the outstanding obligations of the entity meeting the criteria set forth above, if the net value of the entity is determined based upon its net asset value.

B. Requested Clarity in Establishing Minimum Value of Interest in a Parent Entity Holding an Interest in a Subsidiary with an Operating Business

We will discuss the need to clarify whether the rules of § 20.2031-2(f)(2) or 20.2031-3 (for testamentary transfers) or § 25.2512-2(f)(2) or 25.2512-3 (for inter vivos transfers) apply for purposes of determining the minimum value of a parent entity's interest in an operating business held via a subsidiary entity or whether such should be determined strictly on the value of the operating business's underlying property.

IV. Recommended Clarity on Existence of "Put Right"

We will discuss the need to confirm in any revised regulatory guidance the informal assurances provided by representatives of Treasury and the IRS that the Proposed Regulations are not to be interpreted as imputing a "put right" to holders of interests in family-controlled entities.

V. Requested Clarity Regarding Individuals Required to "Control" Entity for Purposes of Prop. Reg. §§ 25.2704-2 and 25.2704-3

We will discuss the need for clarity regarding the individuals whose ownership of interests in an entity are relevant for purposes of determining whether there is the requisite family "control" of the entity and our belief that Treas. Reg. § 25.2702-2(a)(1), rather than Treas. Reg. § 25.2701-2(b)(5), provides the appropriate listing of those individuals. Consistent with that belief, we will suggest that the first sentence of each of Prop. Reg. § 25.2704-2(c) and Prop. Reg. § 25.2704-3(c) correspondingly be revised to read: "For the definition of control, see § 25.2701-2(b)(5)(ii), (iii), or (iv), as applicable."

VI. Requested Clarity Regarding Apparent Broadening of Family Attribution Principles

Our view is the construction of Code § 2704(b)(3)(B) adopted in Prop. Reg. §§ 25.2704-2(b)(4)(ii) and § 25.2704-3(b)(5)(iii) represents a narrowing of the Code § 2704(b)(3)(B) exception to the extent it will have little or no effect and thus will have been rendered meaningless. We believe Treasury and the IRS have exceeded their Congressional authority in proposing adoption of this narrower interpretation. In doing so the Proposed Regulations will have broadened the application of family attribution principles beyond the few instances in which Congress intended it be assumed that family members will unite to disregard actual lapses of voting or liquidation rights or restrictions on an entity's liquidation to substantiate an artificially higher value for a transferred (or deemed transferred) limited partnership interest than would otherwise apply.

We will suggest that Treasury and the IRS revise Prop. Reg. § 25.2704-2(b)(4)(ii) to retain the standard set forth in § 25.2704-2(b) of the current regulations. That regulation specifies an applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally in the absence of the restriction. Correspondingly we will suggest revising Prop. Reg. § 5.2704-3(b)(5)(iii) to provide that a disregarded restriction is a limitation on an interest holder's ability to compel the entity to redeem the holder's interest that is more restrictive than the limitations that would apply under state law generally in the absence of the restriction.

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December 1, 2016

Alyson Outenreath, Chair
State Bar of Texas, Tax Section
1414 Colorado Street
Austin, TX 78701

Re: Comment to Proposed Rule 3.584 (Margin: Reports and Payments)

Ms. Outenreath,

Thank you for the comments you submitted on behalf of the Tax Section of the State Bar of Texas concerning proposed Rule 3.584. Your participation in this process is greatly appreciated.

The rule adoption was filed with the Secretary of State on Nov. 8, 2016, and will be published in the Texas Register on Dec. 2, 2016.

In response to your comments, as well as comments submitted by other tax practitioners and associations, the Comptroller revised the definition of "primarily engaged in retail or wholesale trade" before filing the amendments to Rule 3.584 for adoption. The revised definition more closely follows the previous definition provided in subsection (d)(3) of the rule, with only minor changes to improve readability.

Following the effective date of the amendments, the Comptroller intends to propose additional amendments to Rule 3.584 revising the definition of "primarily engaged in retail or wholesale trade" to address some of the concerns expressed in your comments. The Comptroller does not intend to substantially alter the substance of the guidance set out in STAR Accession No. 201508350L.

Removing the controversial language before adoption of the rule and then proposing another definition in a future rulemaking will allow interested parties the opportunity to comment on the Comptroller's subsequent definition before it is adopted.

The guidance expressed in STAR Accession No. 201508350L remains in effect while the Comptroller continues to consider the comments.

Thank you again for your comments and your careful consideration of the proposed rule.

Sincerely,

Teresa G. Bostick

Teresa G. Bostick
Director, Tax Policy
Texas Comptroller of Public Accounts

TAX SECTION
State Bar of Texas

December 16, 2016

Via E-mail to Gina.Calvino@cpa.texas.gov

Gina Calviño
Legal Assistant, Office of Special Counsel for Tax Hearings
LBJ State Office Building
111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.4, "Representation and Participation"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.4.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT

SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.4, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.4

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.4 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

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Sam.Megally@KLGates.com

Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.4, "Representation and Participation" ("Proposed Rule 1.4" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.4, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

Proposed Rule 1.4(a) sets forth certain requirements for a taxpayer's designation of an authorized representative in the context of a contested case. As currently drafted, it appears that the Comptroller's office intends the first complete sentence of subsection (a) to pertain only to individual taxpayers; we respectfully suggest that the Comptroller's office clarify that intent by beginning that sentence with the phrase "An individual taxpayer may represent himself or herself..." Similarly, it is our understanding that individual taxpayers must designate representatives by written authorization, just as legal entity taxpayers must do; we respectfully suggest that the Comptroller's office clarify the first complete sentence of subsection (a) so that it requires an individual taxpayer to make his or her designation by written authorization.

In addition, as drafted, the Proposed Rule is not clear as to whether an existing power of attorney -- for instance, one executed during an earlier audit that has given rise to a contested case -- remains a sufficient written authorization for purposes of the Proposed Rule; our view is that such an existing power of attorney should remain acceptable after the initiation of a contested case, and we respectfully suggest that the Comptroller's office insert at the end of subsection (a) clarifying language to that effect. Finally, we understand that the Comptroller's office has been considering promulgating a form power of attorney that could serve as the written authorization required by the Proposed Rule; we respectfully request that the Comptroller insert into the Proposed Rule a reference to such form, and circulate to all interested parties a draft of such form prior to finalizing the Proposed Rule and filing it with the Texas Register.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 16, 2016

Via E-mail to Gina.Calvino@cpa.texas.gov

Gina Calviño
Legal Assistant, Office of Special Counsel for Tax Hearings
LBJ State Office Building
111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.8, "Resolution Agreements"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.8.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT

SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.8, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.8

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.8 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

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Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.8, "Representation and Participation" ("Proposed Rule 1.8" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.8, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

The Proposed Rule addresses circumstances in which the Comptroller's office and a taxpayer resolve a contested case by agreement, and sets forth the steps by which the parties may memorialize such an agreement. Subsection (c)(1) provides that Comptroller's office staff are to begin a draft of any such resolution agreement by using a standard form approved by the Comptroller's office. We understand that the Comptroller's office has been preparing a new draft form resolution agreement, and we note respectfully that we cannot comment on the reasonableness of the form agreement requirement in the Proposed Rule without seeing the current draft of such form agreement. As a general matter, however, we respectfully suggest that the Comptroller should consider striking the explicit requirement that agency staff begin with an approved form. Although the Comptroller's office may well elect to maintain such a requirement in its internal policies and procedures, codifying the requirement in the Administrative Code could discourage agency staff from agreeing to reasonable and necessary changes that a taxpayer may request.

We respectfully note as well that the requirement in subsection (b)(4) that no Comptroller's Decision will issue when a contested case is resolved by agreement may in some instances discourage settlements when a single hearing relates to both agreed issues and issues that remain the subject of dispute between the Comptroller's office and a taxpayer. In such a circumstance, absent the issuance of a Comptroller's Decision with respect to the portion of the hearing that remains in dispute -- and the subsequent ability to file a Motion for Rehearing, as required by statute prior to attempting to pursue the claim in court -- a settlement at the administrative level that precludes the issuance of a Comptroller's Decision will not be acceptable to the taxpayer. We respectfully suggest that the Comptroller's office either amend the Proposed Rule so that a Comptroller's Decision may issue if agreed by all parties or, alternatively, provide (whether in the Proposed Rule or in another rule) a mechanism for the bifurcation of issues or periods into separate hearings so that contested issues do not block the parties' ability to resolve agreed issues.

Subsection (c)(7) of the Proposed Rule provides that, when a taxpayer and the Comptroller's office determine and agree that adjustments set forth in a resolution agreement were calculated in error, the parties may execute an amendment to the resolution agreement. We respectfully suggest that, because this subsection is predicated on the parties' agreement as to the error, the Comptroller's office should require agency staff to prepare an amendment that correctly effectuates the parties' intent and send it to the taxpayer for approval and execution.

Finally, subsection (d) provides for the suspension of deadlines in a contested case that is under review by the Comptroller's designated tax dispute office. We respectfully suggest that the Comptroller's office should clearly set forth -- whether in the Proposed Rule or in another rule -- the procedure by which taxpayers may request that their contested cases be considered by the Comptroller's tax dispute office.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 16, 2016

Via E-mail to Gina.Calvino@cpa.texas.gov

Gina Calviño
Legal Assistant, Office of Special Counsel for Tax Hearings
LBJ State Office Building
111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.18, "Filing Documents"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.18.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT

SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.18, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.18

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.18 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.18, "Filing Documents" ("Proposed Rule 1.18" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.18, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

Subsection (e) of the Proposed Rule sets forth the criteria for determining the date on which documents are deemed filed with the Office of Special Counsel for Tax Hearings. We respectfully suggest that the sentence relating to receipt of documents filed by hand-delivery is confusing as drafted, and should be revised so that it reads "A document filed by hand-delivery is considered filed on the date received by staff at the agency's security desk." We note respectfully that the sentence relating to documents filed electronically is also confusing as drafted, and should be revised so that it reads "A document that is filed electronically is considered filed on a date when it is received at any time during the 24-hour period from 12:00 a.m. (midnight) through 11:59 p.m. on that date, and a document received on a day on which the agency is closed is considered filed on the next calendar day on which the agency is open." Additionally, we respectfully suggest that it is not clear what category of documents the final sentence of subsection (e)(1) is intended to address; in any event, that sentence becomes redundant with the changes we have proposed, so we propose that the Comptroller consider deleting the sentence in its entirety.

Finally, we respectfully suggest that the Comptroller should insert into the Proposed Rule a provision allowing a taxpayer to request documentation from the Comptroller demonstrating the date of receipt of a document by the Comptroller; we further propose that the Comptroller explicitly provide in the Proposed Rule that, in the event the Comptroller cannot provide such documentation or such documentation is unclear, alternative probative evidence of the actual date of delivery shall be acceptable in determining the actual date of receipt by the Comptroller.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 16, 2016

Via E-mail to Gina.Calvino@cpa.texas.gov

Gina Calviño
Legal Assistant, Office of Special Counsel for Tax Hearings
LBJ State Office Building
111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.28, "Decisions and Orders"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.28.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT

SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.28, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.28

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.28 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.28, "Decisions and Orders" ("Proposed Rule 1.28" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.28, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

Proposed Rule 1.28 sets forth the procedures by which parties may secure dismissals of contested cases, and the manner and timeframe in which decisions become final. Subsection (c) sets forth the circumstances in which the agency may issue decisions on motions to dismiss, including for a taxpayer's failure to state a claim upon which relief can be granted. Unlike in the litigation context, when parties often have abundant time to consider possible causes of action, in tax administrative disputes, the time that taxpayers and their representatives have to consider their claims prior to various filing deadlines -- including their statements of grounds and their replies to position letters -- can be very compressed. It is our view that at least these preliminary pleadings have consistently, and appropriately, been viewed as notice-pleadings, and we respectfully suggest that it is imperative to maintain this understanding in order to ensure that taxpayers have a reasonable opportunity to raise their claims before the Comptroller's office. A subjective determination by the Comptroller as to the likelihood of prevailing in a contested matter as a basis for unilaterally dismissing a contested claim is problematic. Therefore, we respectfully suggest that the Comptroller's office either strike subsection (c)(3) altogether or, in the alternative, explicitly set forth specific, very narrow circumstances in which a motion to dismiss for failure to state a claim would be appropriate.

Finally, our observation has been that the time between issuance by the State Office of Administrative Hearings of a proposal for decision and the Comptroller's issuance of a final decision can sometimes be extremely long, and taxpayers typically have no way to determine when a final decision might be issued; such delays can create uncertainty as to the Comptroller's intent with respect to the proposals, and can also increase the amount of interest for which a taxpayer is liable. We respectfully suggest that the Comptroller incorporate into the Proposed Rule a standard timeframe -- perhaps 90 days -- following issuance of a proposal for decision within which the agency is required to issue a final decision. To the extent the Comptroller's office requires additional time, we suggest further that the Comptroller's office should be entitled to an extension of such timeframe -- perhaps an additional 45 days. However, we suggest as well that in such circumstances, the agency should be required to explain the reason for the extension in a written submission to the taxpayer so that, if the Comptroller's office is considering revising the proposal for decision, the taxpayer is made aware of such deliberations well in advance of receiving a final decision that differs from the proposal for decision.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 16, 2016

Via E-mail to Gina.Calvino@cpa.texas.gov

Gina Calviño
Legal Assistant, Office of Special Counsel for Tax Hearings
LBJ State Office Building
111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.29, "Motion for Rehearing"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.29.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.29, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.29

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.29 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.29, "Motion for Rehearing" ("Proposed Rule 1.29" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.29, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

Proposed Rule 1.29 sets forth the procedures and requirements for filing motions for rehearing following the issuance of a decision or order. Subsection (d), relating to motions for extension of time, provides that if the Comptroller has not by the 10th day after the initial deadline for the motion for rehearing acted on a motion for extension of time, such motion for extension of time is deemed overruled by operation of law. Our view is that the Comptroller should whenever possible avoid limiting taxpayers' ability to satisfy statutory and administrative requirements, particularly when those requirements have jurisdictional ramifications; the standard articulated in the Proposed Rule, by contrast, has the potential to be a trap for the unwary. Particularly in a circumstance in which a taxpayer has timely submitted a motion for extension of time and shown the need for such an extension, but has received no response from the Comptroller's office, we respectfully suggest that it is arbitrary and inconsistent with sound tax policy to deem such motion for extension of time overruled by operation of law, and we propose that the Comptroller's office reverse the rule so that motions for extension of time on which the Comptroller's office has failed to act are deemed granted by operation of law on the 10th day following the initial deadline for the motion for rehearing.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 16, 2016

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111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.32, "Service of Documents on Parties"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.32.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.32, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.32

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.32 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Sam.Megally@KLGates.com

Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.32, "Service of Documents on Parties" ("Proposed Rule 1.32" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.32, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

The Proposed Rule sets forth the acceptable methods of service of documents on parties to a contested case, and also addresses how the Comptroller's office will determine the date of service in certain circumstances. Subsection (a) of the Proposed Rule provides that a contested case begins as described in Rule 1.5, relating to initiation of a hearing. Rule 1.5 sets forth certain requirements for taxpayers' requests for hearings, but does not specify the time or act that marks the commencement of a contested hearing. We respectfully suggest that it is not clear whether only the Comptroller's office can initiate a hearing, in response to a taxpayer's request for a hearing, and propose that the Comptroller explain its view as to the precise time when a hearing commences, and consider as well clarifying such view in the Proposed Rule. Because the date on which a hearing commences can impact certain deadlines by which taxpayers are bound, and because the Comptroller's office may deny requests for hearing that it finds deficient (for instance, because they are not timely), we respectfully suggest that a contested case may begin on the date on which the taxpayer receives notice that the Comptroller's office has initiated a hearing in response to the taxpayer's request rather than on the date of the taxpayer's request for a hearing.

Finally, subsection (e) of the Proposed Rule sets forth the criteria for determining when service of documents on the agency is complete in certain circumstances. We respectfully suggest that subsection (e)(2), relating to service by fax and email, is confusing as worded; we propose that the Comptroller revise subsection (e)(2) to provide that documents filed by fax or email are considered filed on a date when they are received at any time during the 24-hour period from 12:00 a.m. (midnight) through 11:59 p.m. on that date, and that documents received on a day on which the agency is closed are considered filed on the next calendar day on which the agency is open.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 16, 2016

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Legal Assistant, Office of Special Counsel for Tax Hearings
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111 East 17th Street, Ste. 118
Austin, Texas 78774

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 1.41, "Ex Parte Communications"**

Dear Ms. Calviño:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 1.41.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 1.41, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 1.41

These comments on Proposed Amendments to 34 Tex. Admin. Code § 1.41 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 16, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 1.41, "Service of Documents on Parties" ("Proposed Rule 1.41" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 1.41, including the Comptroller's office's assembling and working closely on the Proposed Rule alongside a drafting group that included members of the SALT Committee. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

The Proposed Rule sets forth the limitations on communications between parties to a contested case and persons assigned to render decisions or make findings of fact and conclusions of law. Subsection (a)(4) sets forth a list of persons who "participate in rendering decisions," and with whom ex parte communications are prohibited, including the Comptroller, and staff of the Office of Special Counsel for Tax Hearings. We respectfully suggest that this provision is inconsistent with and overbroad as compared to Government Code § 2001.061(a), which prohibits ex parte communications only with persons who are "assigned to render a decision or to make findings of fact and conclusions of law," and not all persons who participate in rendering decisions or making findings and conclusions.

The Comptroller's office should err at all times in favor of granting taxpayers unfettered access to Comptroller personnel and protecting taxpayers' ability to discuss with Comptroller personnel a wide range of tax matters. We note respectfully that the Proposed Rule as drafted could become a trap for unwary taxpayers and practitioners who may seek to discuss with the Comptroller or other agency personnel general tax issues, some of which may have an impact on tax matters then in dispute. Our view is that it is particularly important that the Comptroller, who is an elected official, remain available to taxpayers; to the extent the Comptroller elects to delegate tasks to his Deputy Comptroller, we observe that it is likely as well that taxpayers would seek reasonable access to the Deputy Comptroller in connection with meetings to discuss tax matters of importance to taxpayers. In addition, while taxpayers may be able to determine who the Comptroller's Special Counsel for Tax Hearings is, they are unlikely to be able to determine what Comptroller personnel are on the Special Counsel's staff; we respectfully note that broadening the ex parte prohibition to include not just the Special Counsel but also his or her staff goes far beyond the language and intent of Government Code § 2001.061(a). We propose that the Comptroller revise subsection (a)(4) so that the only person with whom ex parte communications are expressly prohibited is the administrative law judge assigned to the contested case.

Finally, subsection (a)(3) of the Proposed Rule provides that the prohibition on ex parte communications applies for the duration of a contested case, "generally begin[ning] with a request for redetermination of a deficiency or jeopardy determination, or a request for hearing following denial of a request for refund." However, we respectfully suggest that it is not clear as a general matter that a taxpayer's request -- as opposed to the Comptroller's notifying the taxpayer that its request has been granted -- actually commences a hearing. Because the date on which a hearing commences can impact certain deadlines by which taxpayers are bound, and because the Comptroller's office may deny requests for hearing that it finds deficient (for instance, because they are not timely), we respectfully suggest that a contested case may begin on the date on which the taxpayer receives notice that the Comptroller's office has initiated a hearing in response to the taxpayer's request rather than on the date of the taxpayer's request for a hearing.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

Texas Society of CPA Certified Public Accountants

TAX SECTION
State Bar of Texas

January 24, 2017

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
P.O. Box 7604; Ben Franklin Station
Washington, D. C. 20044

Re: Limits on the Availability of In-Person Appeals Conferences

Dear Commissioner Koskinen,

On behalf of the Texas Society of Certified Public Accountants (TSCPA) and the Tax Section of the State Bar of Texas, we respectfully submit this joint letter to raise significant concerns by Texas tax practitioners in light of recent revisions to the Internal Revenue Manual that limit the availability of in-person appeals conferences.

TSCPA is a nonprofit, voluntary professional organization representing more than 28,000 members. One of the expressed goals of the TSCPA is to speak on behalf of its members when such action is in the best interest of its constituency and serves the cause of CPAs in Texas, as well as the public interest. TSCPA has established a Federal Tax Policy Committee (FTP) to represent those interests on tax-related matters. The FTP has been authorized by the TSCPA's Board of Directors to submit comments on such matters of interest to committee membership. The views expressed herein have not been approved by the Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policies of the TSCPA.

The comments incorporated into this joint letter are also being presented on behalf of the Committee on Governmental Submissions (COGS) of the Tax Section of the State Bar of Texas. These comments should not be construed as representing the position of the Board of Directors, the Executive Committee or the general membership of the State Bar of Texas. The Tax Section, which has submitted these comments, is a voluntary section of members composed of lawyers practicing in a specified area of law. These comments were approved by the Council of the Tax Section, which is the governing body of that Section. No approval or disapproval of the general membership of this Section has been obtained and the comments represent the views of the members of the Tax Section who prepared them.

Although members of the Tax Section of the State Bar of Texas who participated in preparing these comments have clients who would be affected by the principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

The Office of Appeals recently revised the Internal Revenue Manual (IRM) to limit taxpayers' ability to resolve their tax issues using in-person appeals conferences. While this change in policy was apparently intended to promote efficiency within the Internal Revenue Service (IRS), it constitutes a major change in long-standing policy that protects taxpayer rights. This change may diminish public confidence in the IRS while in many cases actually decreasing efficiency.

Informal statements by the IRS undermine, rather than promote, consistent application of the revised procedures. We understand that representatives of the Office of Appeals have expressed an intention to apply their procedures in a fair manner so as to not unreasonably limit taxpayers' access to face-to-face conferences. Nationwide consistency in access to the appeals process is essential. However, we believe appeals managers' interpretations may vary, particularly as time passes, in implementing informal statements that conflict with the language of the revised IRM procedures. Thus, these statements provide taxpayers and representatives little assurance of consistent application and could undermine already waning taxpayer confidence in the appeals process.

While we generally support the objective of the IRS "Future State" initiative to take advantage of the latest technology to reduce costs, this initiative should be implemented in a manner to enhance the entire taxpayer experience and should not come at the expense of taxpayer appeals rights. We believe the recent change limiting the opportunity for in-person meetings between taxpayers and the Office of Appeals is too restrictive and could, ultimately, even if not immediately, preclude nearly all in-person meetings. Moreover, the technology for holding alternative conferences is currently insufficient to accommodate taxpayers' needs for face-to-face appeals. Accordingly, we make the following comments and suggestions.

Revisions to the Internal Revenue Manual Threaten Taxpayer Rights

Revised IRM 8.6.1.4 entitled "Conference Practices" states that all conferences should be held by telephone except where:

- There are substantial books and records to review,
- The appeals officer cannot judge the credibility of the taxpayer without an in-person conference,
- The taxpayer has special needs that can only be accommodated with an in-person conference,
- There are numerous conference participants,
- An alternative conference procedure will be used involving separate caucuses, or
- Another IRM section calls for an in-person conference.

This list is deficient and fails to account for such factors as the technical difficulty or complexity of the case, either from a factual or legal perspective. The revised procedures should be carefully analyzed for other deficiencies and should be revised to moderate the bias against in-person conferences. Moreover, the criteria listed in the IRM to be applied by the appeals team manager (ATM) are too vague. Reasonable minds could differ on what constitutes "substantial books and records" necessary to transfer the case for a face-to-face conference. Focusing on these types of determinations will distract resources from the substantive appeals process, as the IRS is tasked with the procedural determination of whether a taxpayer's case is worthy of an in-person meeting, rather than spending productive time addressing the merits of the case. Accordingly, we respectfully suggest that the IRS provide clearer guidelines as to what constitutes "substantial books and records" in order for taxpayers and tax practitioners to better be able to determine when it would be necessary for the IRS to schedule the case for a face-to-face conference.

As changed, the IRM requires that in-person conferences first be approved by the ATM rather than the appeals technical examiner (ATE). We believe the ATE, rather than the ATM, would be the more appropriate and efficient person to approve in-person conferences because the ATE has the most contact with the case while it is in Appeals. Accordingly, we recommend that the ATE is better equipped to make the initial determination of whether a case should be set for a face-to-face conference and should be the person with first approval authority for in-person conferences. The ATM would still be available to authorize a case for a face-to-face hearing if the ATE initially recommends against it. Furthermore, we believe the decision on whether a face-to-face conference is appropriate should not be vested solely in the Office of Appeals. Therefore, we suggest that this approval should be a collaborative analysis involving the taxpayer, the tax practitioner and the ATE.

Alternatives to Face-to-Face Appeals Conferences are Often Not Sufficient

The IRS is required to make appeals technical employees available on a regular basis in each state.[1] Moreover, the IRS has been encouraged to consider alternative techniques, such as teleconferences for taxpayers seeking appeals in rural or remote areas. We understand under the new policy, a taxpayer requesting an in-person conference will be offered a video conference (VSD) if the IRS has such a facility within 100 miles of the taxpayer. While, in some instances, this might be an acceptable alternative to an in-person conference, we understand the IRS currently has only 10 such facilities. In addition, in many large states, the VSD service is not likely to be available to a large percentage of the taxpayer population. For example, the only current VSD facility in Texas is in El Paso, which is more than 500 miles from most of the largest cities and population in Texas and in a different time zone from the rest of the state. We encourage the IRS to make VSD more available and to establish definitive procedures for use of VSD. We also understand that current VSD technology is not dedicated to Appeals, a fact that could lead to serious scheduling issues. Time constraints on the use of such technology could also impede fair hearings, the length of which frequently cannot be predicted.

We also encourage the IRS to consider improving the quality of communication before expanding videoconferencing. In our experience, the technology the IRS has historically employed to allow IRS representatives to participate in IRS practitioner liaison meetings has been full of glitches and far less than adequate to assure effective communications. Although videoconferencing can eliminate driving across the city, traveling across the country or sometimes even taking the elevator to get to another floor of the same building, it has been problematic and potential savings to the IRS should not be at the cost of the quality of an in-person meeting. Moreover, since an additional IRS employee will be required to monitor the use of the VSD system while the appeals conference is taking place, the actual cost savings is not apparent.

Kirsten Wielobob, former chief of appeals, responded in a letter to earlier comments of the TSCPA, stating that 87 percent of the cases conducted using telephone communications were "effectively resolved." Although we understand that many cases can be resolved with a telephone discussion, these statistics may not tell the whole story. Efficient resolution could very easily include prompt denial of the relief the taxpayer was seeking. In addition, even if taxpayer relief was granted, we strongly suspect many of the

[1] Internal Revenue Restructuring Act of 1998 §3465(b) and (c). *See also* IRS Pub. 1660, Collection Appeal Rights.

cases behind this statistic involved relatively simple technical matters. While we agree that many such simple cases brought before Appeals can be resolved with a telephone discussion, we suggest that telephone conferences should not be the sole method of resolving all issues and procedures should not be used to reduce the availability of a face-to-face appeal for the cases that are not so easily resolved. Indeed, we suspect that if practitioners perceive that Appeals loses its attractiveness as the next step after a revenue agent's report, recourse to a Tax Court filing with the use of Appeals as a part of that procedure may become more the norm.

Our members often use telephone discussions in the appeals process because it is most efficient for us and our clients. This is particularly important in a state like Texas where an in-person conference might require a taxpayer or representative to travel hundreds of miles both to and from the conference. However, if the taxpayers and their representatives are willing to make the trip because they believe an in-person conference is important to a fair and efficient resolution of issues, they should not be denied the opportunity simply because the telephone conference is the "default" position combined with an administrative policy that Appeals will only permit in-person meetings under the very limited circumstances described in the IRM.

Ms. Wielobob requested that we provide examples of when face-to-face conferences are superior to telephone conferences. The following examples describe many of the types of circumstances where in-person meetings are critical to arriving at a fair and efficient resolution for both the IRS and taxpayers:

- Telephone communication is often not effective for complex factual or legal tax issues that require detailed explanations and/or where taxpayer records are critical to resolving the issue. The IRM references voluminous records as a reason why an appeal may be set for a face-to-face conference. However, the evaluation of what is voluminous is very subjective and the amount of records may not be relevant when dealing with a complex tax issue requiring detailed explanation.
- In-person communication permits both parties to evaluate each other's positions more clearly than mere voice communication. Facial expressions and body language are an effective and efficient means to determine whether the other party understands the points being raised, is raising them sincerely and has a strong belief in the position being asserted. Subtle differences in perspective are more likely to be understood in person using more senses than are available over the phone. Current videoconferencing capabilities, if available, do not pick up these subtleties.

- In-person meetings are important for taxpayers and IRS officials for whom English is a second language or who otherwise have limited communication capacities, which often requires the participants to rephrase questions and answers. This is an important issue in Texas where we have large Hispanic and Asian populations.
- As recognized in the IRM "Conference Practices," in-person meetings are necessary whenever the taxpayer or the taxpayer's representative has a hearing impairment.
- Even where hearing impairment is not an issue, poor telephone audio quality can sometimes interfere with a clear understanding of issues.

In our experience, face-to-face communications have been critical in resolving matters in appeals. In many appeals cases, settlement was easily reached by presenting and discussing a supporting case or documentation, such as a prior tax return, that may not meet the requirements of "substantial books and records" as required for an in-person appeal. While fax machines, scanners and other methods may allow taxpayers, tax practitioners and appeals officers to share additional documents or information during an appeals conference, those methods are not always as effective as physically bringing them to the appeals conference. We also note there are many complex situations that require much telephone and other follow-up, including follow-up in-person conferences.

Limitations on in-person meetings will reduce the ability of taxpayers and the IRS to clearly communicate their respective positions and will be likely to extend and complicate the resolution of the issues, significantly increasing the number of cases requiring judicial review and increasing overall costs for both the IRS and taxpayers.

Finally, since the appeals conference revisions constitute a significant change in long-standing policy, we believe the initiative should not have been implemented by merely adding wording to the IRM. Before implementing any proposal of this importance, the IRS should have requested public comment from those most affected, including taxpayers and tax professionals.

We are attaching two prior letters submitted by TSCPA on this subject, one on preserving and improving access to face-to-face appeals conferences and the other requesting an opportunity to comment on proposed implementation of the IRS Future State plan. Face-to-face appeals conferences are important for Texas CPAs and attorneys, and we respectfully encourage you not to unduly restrict the availability of in-person appeals conferences.

We appreciate this opportunity to communicate and comment on the revisions to the IRM and would be happy to discuss our comments further with you. Please contact Ken Horwitz at 972-419-8383 or kmh@gpm-law.com, or David Colmenero at 214-749-2462 or dcolmenero@meadowscollier.com if you would like to discuss our comments.

Sincerely,

Kenneth M. Horwitz, JD, LLM, CPA
Chair, Federal Tax Policy Committee
Texas Society of CPAs

David E. Colmenero, JD, LLM, CPA
Chair, Tax Section
State Bar of Texas

Principal responsibility for drafting these comments was exercised by Kenneth M. Horwitz, JD, LLM, CPA; David E. Colmenero, JD, LLM, CPA, on behalf of the State Bar of Texas; and Christina A. Mondrik, JD, CPA. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these comments. Jeffry M. Blair, JD; Henry Talavera, JD; and Jason B. Freeman, JD, CPA, vice chair and co-chairs of COGS, respectively, also reviewed these comments. Bob Probasco, JD, CPA, reviewed the comments and made suggestions on behalf of COGS.

cc: Donna C. Hansberry, Chief, Appeals, IRS Office of Appeals
Mary Beth Murphy, Commissioner, IRS Small Business/Self-Employed Division
Nina E. Olson, National Taxpayer Advocate
Texas Members of U.S. Congress

Attachments (2)

474633

Texas Society of
Certified Public Accountants

March 4, 2016

The Honorable Jacob J. Lew
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue NW
Washington, D.C. 20224

RE: Request that the IRS Expose its "Future State" Vision and Concept of Operations for Public Comments

Dear Secretary Lew and Commissioner Koskinen:

The Texas Society of Certified Public Accountants (TSCPA) is a nonprofit, voluntary professional organization representing more than 27,000 members. One of the expressed goals of the TSCPA is to speak on behalf of its members when such action is in the best interest of its constituency and serves the cause of CPAs in Texas, as well as the public interest. TSCPA has established a Federal Tax Policy Committee (FTP) to represent those interests on tax-related matters. TSCPA has also established the Relations with IRS Committee to create and maintain communications with the Internal Revenue Service (IRS). These committees have been authorized by TSCPA's Board of Directors to submit comments on such matters of interest to committee membership. The views expressed herein have not been approved by the Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policies of the TSCPA.

We are pleased to learn that the IRS is creating a "future state" plan within its Concept of Operations (CONOPS) to improve service to taxpayers and practitioners. However, we are concerned the plan may substitute electronic interaction for in-person communications in many situations where this may not be efficient or efficacious either for the IRS or for the public. We appreciate the recent inclusion of material on the IRS website relating to this plan, acknowledging the receipt of input from specified, but limited groups and persons. However, we urge you to expose the CONOPS plan for general public review and comment, as parts are in development, from time to time during the planning process. This process should occur well before any adoption or implementation of any part so that the IRS may benefit from the practical perspective of practitioners and the public.

In many instances, electronic interactions will be less adequate than in-person communications. Tax issues are often complex, and we expect taxpayers and their professional advisors, however sophisticated, will frequently not ask the right questions online or, the online answers will be incomplete or will lead to additional questions. Many of us see this problem now in our communications by email with clients that impel actual interactive direct telephone or in-person communication. In contrast, a brief discussion with an IRS staff person could help clarify the issues and provide an opportunity for any necessary follow-up questions, thereby enhancing efficacy for both the IRS and the taxpayer.

14651 Dallas Parkway, Suite 700 • Dallas, TX 75254-7408 • 972/687-8500 • 800/428-0272 • Fax 972/687-8646

Additionally, many individuals, including lower-income and elderly taxpayers, may not have access to appropriate technology or may be less than adequately technologically oriented. Taxpayers who do not fluently speak or read Standard American English, who are not cognoscenti in respect of the special language used in connection with federal tax issues, or who have difficulty with written communication, such as relatively lower educated persons or dyslexic persons, may be severely hindered by the move toward more electronic and fewer spoken taxpayer communications.

As noted in the National Taxpayer Advocate's 2016 Report to Congress, the CONOPS plan may drive the most vulnerable classes of taxpayers to rely on third parties, not all of whom may be scrupulous (or trained) tax professionals, to assist them in communicating with the IRS.[1] Especially if these communications are not limited to Circular 230 regulated practitioners, taxpayers run the risk of increased cost, not to mention increased risk, in communicating with the IRS.

Many taxpayers are very reasonably suspicious of communicating with the IRS using technology. Frequent reports identify IRS data breaches of sensitive taxpayer information.[2] As recently as Feb. 9, 2016, the IRS reported additional data breaches in its Electronic Filing PIN system, which was designed to protect taxpayers from harm.[3]

As the IRS moves toward increased use of technology to serve taxpayers, we want to help identify situations where technology will be most useful and efficacious, as well as those circumstances where it may not be an efficient substitute for personal taxpayer service.

The process of "modernizing" communications, as well as other initiatives that might be proposed in the CONOPS, is important to taxpayers and tax practitioners. Accordingly, for the reasons stated above, we believe that the CONOPS and its parts should be presented for collaborative review and comment by the public well before any anticipated adoption or implementation date.

We appreciate this opportunity to present our comments and would be happy to discuss this further with you. Please contact me at 972-419-8383 or kmh@gpm-law.com if you would like to discuss our comments.

Sincerely,

Kenneth M. Horwitz

Kenneth M. Horwitz, JD, LLM, CPA
Chair, Federal Tax Policy Committee
Texas Society of Certified Public Accountants

Michael D. Williams, CPA

Michael D. Williams, CPA
Chair, Relations with IRS Committee
Texas Society of Certified Public Accountants

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1 Taxpayer Advocate Service- Fiscal Year 2016 Objectives Report to Congress – Volume One, page 64.

2 *See Id.* at p. 61.

3 *See* IRS Statement, available online at: https://www.irs.gov/uac/Newsroom/IRS-Statement-on-Efiling-PIN, as reported by The Journal of Accountancy *at* http://www.journalofaccountancy.com/news/2016/feb/irs-data-breach-exposes-social-security-numbers-201613868.html?utm_source=mnl:cpainsider&utm_medium=email&utm_campaign=16Feb2016.

cc: The Honorable Mark J. Mazur, Assistant Treasury Secretary for Tax Policy
The Honorable Orrin G. Hatch, Chairman, U.S. Senate Finance Committee
The Honorable Ronald L. Wyden, Ranking Member, U.S. Senate Finance Committee
The Honorable Kevin Brady, Chairman, U.S. House Ways & Means Committee
The Honorable Sander M. Levin, Ranking Member, U.S. House Ways & Means Committee
Members of Congressional Caucus on CPAs and Accountants
Texas Members of U.S. Congress
Nina E. Olson, National Taxpayer Advocate

Texas Society of
Certified Public Accountants

May 13, 2016

The Honorable John Koskinen
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

RE: Preserving and Improving Access to Face-to-Face Appeals Conferences

Dear Commissioner Koskinen:

The Texas Society of Certified Public Accountants (TSCPA) is a nonprofit, voluntary professional organization representing 27,000 members. One of the expressed goals of the TSCPA is to speak on behalf of its members when such action is in the best interest of its constituency and serves the cause of CPAs in Texas, as well as the public interest. TSCPA has established a Federal Tax Policy Committee (FTP) to represent those interests on tax-related matters. The FTP has been authorized by the TSCPA's Board of Directors to submit comments on such matters of interest to committee membership. The views expressed herein have not been approved by the Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policies of the TSCPA.

Importance of Face-to-Face Appeals

The appeals process is essential to the fairness of our tax system. The recent implementation of the Appeals Judicial Approach and Culture (AJAC) has significantly reduced taxpayers' ability to meet face-to-face with appeals officers to resolve tax issues. In addition, staffing reductions and reallocation of appeals and settlement officers to IRS service centers has seriously degraded access for in-person appeals conferences. This has resulted in delays and increased costs for both taxpayers and the IRS. Face-to-face communications are the most efficient way to deal with complex issues, allow both sides to evaluate the importance of each other's arguments, focus on and evaluate the strengths and weaknesses of facts and issues, and properly assess litigation hazards. Face-to-face communications are simply more effective than telephone calls, ongoing correspondence or video conferences because it is easier to ascertain if the message sought to be conveyed is effectively communicated to and understood by the recipient.

Virtual Service Delivery and Other Alternatives

Appeals has long been an effective alternative dispute resolution system. We believe the availability of face-to-face meetings is important to the appeals process, but in a large state like Texas, the taxpayer often has to bear substantial costs and burdens in traveling long distances, possibly with multiple trips if the taxpayer is referred back and forth between Appeals and Examinations or Collections. (We note, for those unfamiliar with distances in Texas, that El Paso is closer to Los

Angeles than to Dallas, and Dallas is closer to Chicago than to El Paso.) We appreciate that the IRS is starting to make virtual service delivery (VSD) available in offices distant from major cities like Dallas, Houston, Austin, San Antonio, El Paso, etc. and, of course, this concept is equally true for taxpayers distant from a major city in other states. While we have not observed such a process, we doubt that it is capable of being as effective as face-to-face communications. We do believe it has the potential to be better than handling an appeal only by telephone or correspondence. Many firms have video conferencing facilities, and practitioner groups and organizations might add this capability if the IRS system is a high-quality technology and it promotes VSD availability and procedures. (We note that we have seen the current IRS video conferencing capability and we hope that the quality of the IRS VSD technology is superior to the video conferencing.) Given the clear superiority of face-to-face meetings to settle conflict, we continue to urge the IRS to also consider having Appeals personnel "ride the circuit," visiting various field offices on a regular schedule to meet with taxpayers and tax practitioners to resolve cases.

Another issue is that VSD is a general IRS system and not specific to Appeals, which impacts its availability. Appeals staff must obtain access to the VSD conferencing room through another department. Many Appeals staff members do not even know the system capabilities at this point. We hope the IRS will implement procedures for taxpayers and their representatives to schedule appointments to use the VSD conferencing rooms to meet virtually with the IRS officers from their remote locations.

AJAC has Hindered Appeals Effectiveness

The IRS intended AJAC to separate the fact-finding function of Examinations and Collections from the negotiation and decision-making function of Appeals. Although we understand the burden that was being placed on Appeals and appreciate the efforts to encourage case resolution at earlier levels in Examination and Collections, we note that appeals officers (and settlement officers) have long had authority to send improperly developed cases back to the field—and that authority extended and extends to cases docketed in Tax Court.[1] These efforts were stimulated because some practitioners were less than forthcoming with agents and revenue officers, at least in part because of perceptions that facts presented and efforts to resolve issues at the field level are frequently met with less than open minds. We suggest that while the goal is admirable, the resolution to impose AJAC is not having the intended effect and is instead resulting in a deprivation of taxpayer rights. In operation, the AJAC approach has been used to manage the age of Appeals' caseload and, at least in its practical application, has effectively undermined the availability of a fair and efficient appeals system. The National Taxpayer Advocate has described many of the issues, including that AJAC is:

- Being used to intimidate taxpayers and deny their right to an administrative appeal;
- Causing cases to bounce back and forth between Appeals and Compliance; and
- Resulting in curtailed review by appeals hearing officers of IRS Examination and Collection actions.[2]

[1] Rev. Proc. 2016-22, 2016-15 IRB 577 (March 23, 2016).
[2] National Taxpayer Advocate's 2015 Annual Report to Congress, MSP #8, 83.

These problems are fully described in her report, which mirrors the experience of many of our members. For example, if the taxpayer has not submitted all files, Appeals will automatically refer the case back to Examinations or Collections. We believe the appeals officer should be able to independently evaluate the importance of facts and issues and fully develop the case in Appeals if it is determined that is the most efficient way to proceed. Automatically referring the case back to Examinations or Collections results in delays and added costs for the taxpayer (and, we suspect, the IRS). The AJAC process imposes mandatory and unrealistically limiting deadlines in which to resolve facts and issues. Taxpayers have no control over the timing of the assignment of the referred case. Given the lack of adequate field-level personnel, IRS delay can be lengthy. Thus, if the taxpayer, after the case is finally assigned, cannot promptly satisfy Examinations' or Collections' system-imposed tight deadlines for information, the taxpayer could receive a statutory notice of deficiency forcing the dispute into the likely more costly forum of the Tax Court. This is particularly onerous for taxpayers with limited resources and clearly violates the Appeals mission statement that is posted prominently in Appeals' offices. Further complication arises if the case is filed in Tax Court based on the Appeals-generated Notice of Deficiency because referral of the case back to Appeals for settlement is discretionary.[3]

Automatic application of AJAC procedures reduces the quality of appeals and diminishes the role of appeals officers, allowing Examinations and Collections to judge the reasonableness of document requests with little opportunity for the taxpayer to get a more objective determination of whether an alternative form of substantiation would suffice. In many cases, Appeals could easily review a new fact or argument rather than sending it back to Examinations or Collections and for many years highly trained appeals officers exercised this discretion. Additionally, requiring that the facts be supported by full documentation before Appeals will consider the case seems to contradict the long-standing *Cohan* rule,[4] which allows taxpayers to produce alternative substantiation in certain circumstances.

Regardless of whether AJAC is being used to pressure the taxpayer to settle, the taxpayer must consider additional costs, procedural delays, and possible hazards of litigation resulting from AJAC procedures. We are concerned this might also be considered by the IRS taking negotiating positions. Some of our members believe appeals officers sometimes seem to apply AJAC procedures in an adversarial way to encourage settlements or to manage their caseload to satisfy internal reporting statistics, forcing settlement without a meaningful review of the facts and issues in Appeals. While the AJAC procedures may reduce the number of pending cases in Appeals, the cost to taxpayers generally increases and the quality of review and fairness generally decreases, clearly in contradiction to Appeals' mission statement.

Conclusion

In separate comments on the "future state" plan of the IRS, we observed the strong need for human interaction with the IRS. This also applies at least equally in cases within the Appeals jurisdiction in which substantial taxpayer rights are at stake.

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[3] Ibid, Rev. Proc. 2016-22, Section 3.01.

[4] *Cohan v. Commissioner*, 39 F 2d 540 (2d Cir. 1930)

We believe the National Taxpayer Advocate has done an excellent analysis of face-to-face appeals problems from AJAC procedures and has made recommendations that should be strongly considered. We particularly support the recommendation to give IRS appeals and settlement officers more discretion to develop facts and arguments rather than being required to automatically bounce a case back to Examinations or Collections. This will allow the appeals (settlement) officer to fully develop the case and will add substantially to the quality of the appeals process. If a case is remanded to the field, the rigid and limited time for field action should be significantly relaxed to provide a fair process. The objective should be to resolve a case fairly and efficiently rather than following procedures that automatically limit the authority of Appeals and which will often delay and effectively deny appeal rights of taxpayers.

We recognize the IRS has to prioritize the use of its scarce workforce resources and funding, but an effective and fair appeals process is necessary for a fair tax system; procedures (whether by AJAC, personnel allocation or otherwise) that limit face-to-face meetings or impair a fair process should not be imposed to restrict a fair appeals process. Travel costs are borne by the taxpayer, and face-to-face meetings make the IRS more efficient and cost effective, and lead to a more efficacious approach to achieving the Appeals' mission of fairness. The IRS should encourage rather than discourage in-person appeals.

We appreciate this opportunity to present our comments and would be happy to discuss this further with you. Please contact me at 972-419-8383 or kmh@gpm-law.com if you would like to discuss our comments.

Sincerely,

Kenneth M. Horwitz, JD, LLM, CPA
Chair, Federal Tax Policy Committee
Texas Society of Certified Public Accountants

Principal responsibility for drafting these comments was exercised by Kenneth M. Horwitz, JD, LLM, CPA; Christina A. Mondrik, JD, CPA; and Julie Ann Dale, CPA.

cc: Nina E. Olson, National Taxpayer Advocate
Karen Schiller, Commissioner, IRS Small Business/Self-Employed Division
Kirsten B. Wielobob, Chief, Appeals, IRS Office of Appeals

TAX SECTION
OF
THE STATE BAR OF TEXAS

2016 – 2017 CALENDAR

June 2016	
6	**Pro Bono Calendar Call-Houston**
8	**2016-2017 Tax Section Officer Planning Retreat** Meadows Collier 901 Main Street, Suite 3700, Dallas, TX 75202 11:30 a.m. – 3:30 p.m.
8 – 10	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
15	**Leadership Academy Reception & Dinner @ Reata Restaurant** 310 Houston Street Fort Worth, TX 76102 6:30 p.m. Reception & 7:00 p.m. Dinner
15 - 17	**Leadership Academy Program (2nd of 4 programs)** Fort Worth Omni and Convention Center 1300 Houston St. Fort Worth, TX 76102
16	**2016-2017 Tax Section Council Planning Retreat** Location: City Club, Speaker's Room – 4th Flr. 301 Commerce St. Fort Worth, TX 76102 1:00 p.m. - 4:00 p.m.
16	**2016 Tax Section Annual Meeting Speaker's Dinner** Reata Restaurant 310 Houston St. Fort Worth, TX 76102 Cocktails @ 6:30 p.m. – Roof Top Terrace Dinner @7:30 p.m.- the Dome
16	**Presentation of Law Student Scholarship Awards** Award Presentations at State Bar Annual Meeting, Speakers' Dinner Reata Restaurant 310 Houston St. Fort Worth, TX 76102 Cocktails @ 6:30 p.m. – Roof Top Terrace Dinner @7:30 p.m.

17	**2016 Tax Section Annual Meeting Program** Fort Worth Omni and Convention Center 1300 Houston St. Fort Worth, TX 76102
17	**Presentation of 2016 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Program
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# Jeff Blair hosting 9:00am
28	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
July 2016	
14-16	**Texas Bar College** Summer School Moody Gardens Hotel Galveston, TX
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
25	**SBOT Chair and Treasurer Training** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
26	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
August 2016	
4 – 9	**ABA Annual Meeting** **Taxation Section – Aug. 5th @ Four Seasons** San Francisco, CA
16	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
23	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
26	**Meeting of Council, Committee Chairs, and Committee Vice Chairs (up to 30-40 pp)** Hosted by Jones Day Dallas, TX 10:30 a.m. – 12:30 a.m. w/lunch Dial-in information will be distributed via email.
27	**Tax Resolution Day (for Taxpayers scheduled for the 9/26 and 10/17 trial sessions** **9:00 a.m. – 12 Noon (extend timeframe if needed)**
Sept 2016	
12	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Houston

15	**Deadline for Appointment of Tax Section Nominating Committee** Chair: David Colmenero
16	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel mspiegel@mayerbrown.com
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
22	**Leadership Academy Tour – Menil Collection &** **Dinner-Link Lee Mansion – Univ. of St. Thomas** **Houston, TX** 5:00 p.m.
23	**Leadership Academy (3rd of 4 programs)** Law Offices of Norton Rose Fulbright Houston, TX 8:15 a.m.
26	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Dallas
27	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
29	**ABA Joint Fall CLE Meeting** Westin Boston Waterfront Boston, MA
Oct 2016	
4	**State and Local Tax Committee Annual Comptroller Briefing** **Co-Sponsored with TSCPA and TEI** Austin, TX
7	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
15	**Tax Resolution Day (for Taxpayers scheduled for the 11/14 and 11/28 trial sessions** **9:00 a.m. – 12 Noon (extend timeframe if needed)**
17	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Dallas
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
19	**Outreach to Law Schools** Southern Methodist University Dedman School of Law Dallas, TX
25	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**

25-26	**Advanced Tax Law Course** **Co-Sponsored with TexasBarCLE** Location: TBD Austin, TX Note: Information re: program, registration and hotel will be available 2 mths. prior to program date.
28-29	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting** **San Francisco, CA**
31*	**Pro Bono Calendar Call** **Regular and Small Tax Case Calendar** **United States Tax Court** El Paso ***Note: *10/31 (3) - Starting Date (Duration)***
Nov 2016	
3	**Pro Bono Calendar Call** **Regular & Small Tax Case Calendar** **United States Tax Court** Lubbock ***Note: *11/03 (2) - Starting Date (Duration)***
3	**19th Annual International Tax Symposium** **Co-Sponsored with the Dallas CPA Society** Cityplace Conference Center Dallas, TX
3	**Outreach to Law Schools** Texas Tech University School of Law Lubbock, TX
4	**19th Annual International Tax Symposium** **Co-Sponsored with the Houston CPA Society** 777 Post Oak Blvd., Suite 500 Houston, TX 77056
10	**Meeting of Council** (approx. 20-24pp) Meadows Collier 901 Main Street, Suite 3700, Dallas, TX 75202 Dallas, TX 10:30 a.m. – 12:30 a.m. w/lunch
14	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Dallas
15	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
22	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**

28	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Dallas
Dec. 2016	
5	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Houston
13	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
27	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
Jan. 2017	
6	**Nomination Period Opens for 2017 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2017 • Nomination forms to be posted on website and distributed via eblast • Submit nomination forms to Tax Section Secretary: Catherine Scheid (ccs@scheidlaw.com)
9	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** San Antonio
13	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel88@gmail.com
16	**Application Period Opens for Law Student Scholarship Program**
17	**Leadership Academy Happy Hour w/Austin Chapter CPA Leap Group** **Charles Johnson House** **Austin, TX** 6:00 p.m.– 9:00 p.m.
18	**Leadership Academy (4th of 4 programs)** **Norton Rose Fulbright** **Austin, TX** 8:15 a.m. – 5:00 p.m.
18	**Leadership Academy Graduation Dinner w/Emily Parker** **Max's Wine Dive** **Austin, TX** 6:00 p.m. – 8:30 p.m.
19	**Outreach to Law Schools** Texas A&M Law School Fort Worth, TX
19-21	**ABA Midyear Meeting** Hilton Bonnet Creek & Waldorf Astoria Orlanda, FL

24	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
24	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
27	**Meeting of Council, Committee Chairs, and Committee Vice Chairs (up to 30-40 pp)** Hosted by Norton Rose Fulbright Houston, TX 10:30 a.m. – 12:30 a.m. w/lunch Dial-in information will be distributed via email**.**
30	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Dallas
Feb. 2017	
3	**Tax Law in a Day CLE** Location: Dallas (Cityplace Conference Center)
13	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Houston
17	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
28	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
March 2017	
1	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
6	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Houston
	Calendar Call - Dallas
	Calendar Call – San Antonio
7	**Law School Outreach – The University of Texas at Austin School of Law** **Austin, TX**
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am

27	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Houston
28	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
29	**Law School Outreach – UNT Dallas College of Law** **Dallas, TX**
April 2017	
1	**Nominations for Outstanding Texas Tax Lawyer Due to Catherine Scheid** Email**:** (ccs@scheidlaw.com)
6	**Law School Outreach - University of Houston Law Center** **Houston, TX**
7	**Law Student Scholarship Application Deadline**
11	**Nominating Committee Report Due to Council**
14	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel88@gmail.com
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
21	**Meeting of Council (20-24 pp)** Meadows Collier 901 Main Street, Suite 3700, Dallas, TX 75202 10:30 a.m. – 12:30 a.m. w/lunch **Note: Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award**
24	**Pro Bono Calendar Call** **United States Tax Court** Dallas
24	**Pro Bono Calendar Call** **United States Tax Court** Houston
25	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
	Property Tax Committee Meeting and Legal Seminar Location: TBD
May 2017	
1	**Pro Bono Calendar Call** **United States Tax Court** San Antonio
11-13	**ABA May Meeting** Grand Hyatt Washington, DC
23	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am

23	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
June 2017	
5	**Pro Bono Calendar Call** **United States Tax Court** Dallas
14-16	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
22-23	**SBOT Annual Meeting** Hilton Anatole Dallas, TX
22	**Tax Section Council Planning Retreat** Hilton Anatole Dallas, TX 1:00 p.m. - 4:00 p.m.
22	**2017 Tax Section Annual Meeting Awards and Speakers' Dinner** Location: Sambuca Dallas, TX
22	**Presentation of 2017 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Awards and Speakers' Dinner Sambuca Dallas, TX
22	**Presentation of Law Student Scholarship Awards** Awards Presentation During Tax Section Annual Meeting Awards and Speakers' Dinner Location: Sambuca Dallas, TX
23	**2017 Tax Section Annual Meeting CLE Program** Hilton Anatole Dallas, TX

TAX SECTION

STATE BAR OF TEXAS

LEADERSHIP ROSTER

2016-2017

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TAX SECTION

THE STATE BAR OF TEXAS

COMMITTEE CHAIRS AND VICE CHAIRS

2016-2017

COMMITTEE	CHAIR	VICE CHAIR
1. **Annual Meeting**	**Ben Vesely** BDO USA, LLP 700 N. Pearl St., Suite 2000 Dallas, Texas 75201 214-665-0763 bvesely@bdo.com	**N/A** (Planning Committee)
2. **Continuing Legal Education**	**J. Michael Threet** Haynes & Boone, LLP 2323 Victory Ave., Suite 700 Dallas, Texas 75219 214-651-5091 michael.threet@haynesboone.com	**Amanda Traphagan** Seay Traphagan 807 Brazos St., Suite 304 Austin, Texas 78701 512-582-0120 atraphagan@seaytaxlaw.com **Jim Roberts** Glast, Phillips & Murray, PC 14801 Quorum Dr., Suite 500 Dallas, Texas 75254 972-419-7189 jvroberts@gpm-law.com
3. **Corporate Tax**	**Jeffry M. Blair** Hunton & Williams, LLP 1445 Ross Ave., Suite 3700 Dallas, Texas 75202 214-468-3306 jblair@hunton.com **Ryan Gardner** Gardner Firm PLLC 6793 Old Jacksonville, Ste. B Tyler, Texas 75703 903-705-1101 rg@glgtx.com	

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4. **Employee Benefits**	**Susan A. Wetzel** Haynes & Boone 2323 Victory Ave., Suite 700 Dallas, Texas 75219 214-651-5389 susan.wetzel@haynesboone.com	**(Joe) Robert Fowler** Baker Botts, LLP 910 Louisiana St. Houston, Texas 77002-4995 713-229-1229 rob.fowler@bakerbotts.com
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		James R. Griffin Jackson Walker 901 Main St., Suite 600 Dallas, Texas 75202 214-953-5827 jgriffin@jw.com
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		Hersh Verma Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5151 hersh.verma@nortonrosefulbright.com

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6. **Estate and Gift Tax**	**Celeste C. Lawton** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5278 celeste.lawton@nortonrosefulbright.com	**Matthew S. Beard** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main St., Suite 3700 Dallas, Texas 75202 214-749-2450 mbeard@meadowscollier.com
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15. Tax-Exempt Organizations	**Terri Lynn Helge** Texas A&M University School of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817-429-8050 thelge@law.tamu.edu	**[Pending]**
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COMMITTEE	CHAIR	VICE CHAIR
17. Newsletter	**Michelle Spiegel** Houston, Texas 832-389-6245 michelle.spiegel88@gmail.com	
18. Tax Law in a Day	**Lora G. Davis** Davis Stephenson, PLLC 100 Crescent Court, Suite 440 Dallas, Texas 75201 214-396-8801 lora@davisstephenson.com	
19. Pro Bono	**Juan F. Vasquez, Jr.** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 1200 Smith Street, 14th Floor Houston, Texas 78205 713-654-9679 juan.vasquez@chamberlainlaw.com	**Jaime Vasquez** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 112 East Pecan Street, St 1450 San Antonio, Texas 78205 210-507-6508 jaime.vasquez@chamberlainlaw.com **Tiffany Hamil** Law office of Tiffany Hamil 6440 N. Central Expressway Turley Law Center 316 Dallas, TX 75206 214-369-0909 dfwtaxadvisor@gmail.com **Joseph Perera** Strasburger 2301 Broadway Street San Antonio, TX 78215 210-250-6119 joseph.perera@strasburger.com

COMMITTEE	CHAIR	VICE CHAIR
20. Leadership Academy	**Christi Mondrik** Mondrik & Associates 11044 Research Blvd., Suite B-400 Austin, Texas 78759 512-542-9300 cmondrik@mondriklaw.com **Robert C. Morris** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-8404 robert.morris@nortonrosefulbright.com	N/A (Planning Committee)