UPDATES AND OTHER TIDBITS

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KENNETH WOOD NAMED ACTING DIRECTOR OF I.R.S. TRANSFER PRICING OPERATIONS

On July 24, the I.R.S. selected Kenneth Wood, senior manager in the Advance Pricing and Mutual Agreement Program, to replace Samuel Maruca as acting director of Transfer Pricing Operations. The appointment took effect on August 3, 2014. We previously discussed I.R.S. departures, including those in the Transfer Pricing Operations, here.

To re-iterate, it is unclear what the previous departures signify—whether the Large Business & International Division is being re-organized, or whether there are more fundamental disagreements on how the Base Erosion and Profit Shifting ("B.E.P.S.") initiative affects basic tenets of international tax law as defined by the I.R.S. and Treasury. Although there is still uncertainty about the latter issue, Ken Wood's appointment seems to signify that the Transfer Pricing Operations' function will remain intact in some way.

CORPORATE INVERSIONS CONTINUE TO TRIGGER CONTROVERSY: PART I

President Obama echoed many of the comments coming from the U.S. Congress when he recently denounced corporate inversion transactions in remarks made during an address at a Los Angeles technical college. As we know, inversions are attractive for U.S. multinationals because as a result of inverting, non-U.S. profits are not subject to U.S. Subpart F taxation. Rather, they are subject only to the foreign jurisdiction's tax, which, these days, is usually lower than the U.S. tax. In addition, inversions position the multinational group to loan into the U.S. from the (now) foreign parent. Subject to some U.S. tax law restrictions, interest paid by the (now) U.S. subsidiary group is deductible for U.S. tax purposes with the (now) foreign parent booking interest at its home country's lower tax rate.

"Inverted companies" have been severely criticized by the media and politicians as tax cheats that use cross-border mergers to escape U.S. taxes while still benefiting economically from their U.S. business presence. This has been seen as nothing more than an unfair increase of the tax burden of middle-income families.

The latest legislative proposals to "combat" inversion are being developed by Rep. Sander Levin (D-Mich.). Rep. Levin's bill will focus on certain aspects of the anti-inversion section currently in the tax law, Code §7874, with a retroactive effective date of May 8th. As to the outbound transaction itself, the bill would limit continuous ownership of the newly inverted company by former shareholders or partners in the original domestic business, treating the new company as domestic for tax purposes if those owners hold more than 50% interest. A merged company would be treated as domestic if management and control of the merged company remained in the U.S. and if 25% of its employees, employee compensation, income, or assets were located or derived in the U.S.

With respect to the inbound loan to the U.S., the bill would limit deductibility of interest for U.S. tax purposes by (i) repealing any safe harbor debt-to-equity ratio (currently 1:5-1:0), (ii) reducing the permitted net interest expense to no more than 25% (from 50%) of the entity's adjusted taxable income (essentially E.B.I.T.D.A.), and (iii) limiting the carryforward of excess interest to five years from the current unlimited carryforward period.

In addition, Rep. Levin's bill will amend Code §956 to include in the Subpart F definition of earnings invested in U.S. property accumulated earnings lent by C.F.C.'s to non-C.F.C. foreign affiliates where the latter use the funds to make investments into the U.S. without incurring tax at the shareholder level. This would be done by expanding Code §956 to require that stock and debt obligations of non-C.F.C. foreign affiliates held by C.F.C.'s trigger current U.S. income taxes to U.S. shareholders.

Given the difficulty of Congress to pass legislation of any substance, and the perceived urgency of the inversion issue, Stephen Shay, a former senior U.S. Treasury Department Official, has suggested that the President could invoke Code §385, which has been in the Internal Revenue Code since 1969 and grants Treasury the regulatory authority to determine when a financial instrument can be treated as debt. To the extent pending inversion transactions anticipate net tax benefits from loans back into the U.S., Mr. Shay may have a point. Code §385 remains essentially dormant today. Regulations were drafted at one point but later withdrawn.

The issue that is faced by the President in pursuing Mr. Shay's suggestion in the current political environment would be whether this would be considered another example of "executive overreach." Query whether the perceived urgency of the inversion situation would offset this concern.

CORPORATE INVERSIONS CONTINUE TO TRIGGER CONTROVERSY: PART II

In what would be an embarrassing disclosure for persons other than opinionated politicians, it was publicized in August that the Obama Administration assisted a Michigan company in a corporate inversion as part of the auto industry bailout. In 2009, the Treasury Department authorized spending $1.7 billion to assist Delphi Automotive, a Michigan parts-maker integrated with Chrysler Corporation, to reorganize as a British company, Delphi Automotive PLC. As reported by the Wall Street Journal, executives continue to run Delphi Automotive PLC from Detroit, but it runs a plant in England, potentially reducing the company's U.S. tax liability by as much as $110 million a year. Although Rep. Sander Levin remained silent on the inversion of the Michigan company, President Obama is blaming smart accountants who apparently think too much.

The Obama Administration is now trying to rescind the tax benefits of the Delphi deal that it helped facilitate. In June, the I.R.S. told Delphi that the inversion should be disregarded for tax purposes through the application of Code §7874; a securities filing reports that the company will vigorously contest the I.R.S. position.

"The Bring Jobs Home Act (S. 2569) is a Democrat-sponsored proposed legislation designed to give companies a tax incentive to relocate jobs to the U.S. and a penalty for moving jobs elsewhere."

I SAY INSOURCING; YOU SAY OUTSOURCING - LET'S CALL THE WHOLE THING OFF

The Bring Jobs Home Act (S. 2569) is a Democrat-sponsored proposed legislation designed to give companies a tax incentive to relocate jobs to the U.S. and a penalty for moving jobs elsewhere. The measure would offer a 20% tax credit to companies that relocate jobs to the U.S., while denying deductions to companies that move jobs away from the U.S. It mimics a bill by Sen. Debbie Stabenow.

Republicans had vowed amendments on tax-related issues, including one to repeal the Affordable Care Act's excise tax on medical devices, which Senate Majority Leader Harry Reid (D-Nev.) has said he wants to protect. Republicans also called for amendments on non-tax matters, environmental, and others. Senator Reid finally avoided formal consideration of the Republican amendments to the bill but could not obtain the 60 votes necessary to end debate and bring the bill to a Senate vote. Accordingly, it appears at least for now, the bill will not get out of the Senate.

L.L.C. CAN CONDUCT BUSINESS SEPARATE FROM ITS OWNER DESPITE DISREGARDED STATUS

The I.R.S. recently indicated that a limited liability company ("L.L.C.") treated as a disregarded entity with respect to its sole member company may conduct a separate and distinct business that is eligible to elect its own method of accounting.

Code §446(d) allows a choice of an accounting method at the trade or business level. A factual determination is made to determine whether a business or trade is separate. Thus, the fact that the L.L.C. failed to make an election to be treated as a corporation (and is disregarded as an entity separate from the corporation for federal income tax purposes), does not signify that the L.L.C. cannot be a separate and distinct trade or business. This is true even if the management of both the sole member company and the L.L.C. are the same. In our view, this ruling may have wider application and taxpayer benefits than one would think. It accepts the commercial reality that different businesses do have different financial metrics by which they operate. The ruling is important from that perspective in that it does not impose an artificial barrier against aligning business financial metrics with tax reporting.

UNRESOLVED QUESTIONS ABOUT THE NET INVESTMENT INCOME TAX ("N.I.I.T.") ADDRESSED

Our firm wrote about the N.I.I.T. in *Insights, No. 1*, *Volume No. 1,* which can be read here. Our firm also presented this topic at the annual CA Professional Seminars in December 2013, in Toronto, Canada.

As 2013 was the first year that the N.I.I.T. was in effect, practitioners were unsure how to allocate expenses and calculate deductions with regard to trusts and estates that paid the N.I.I.T, specifically where income and deductions that were excluded from one tax base were not excluded from another. Practitioners that were accustomed to estimating tax payable due to the distributable net income ("D.N.I.") regime are finding that using those same procedures to calculate N.I.I.T. could lead to erroneous results.

Dual Tax Base

For a domestic trust or estate, the 3.8% tax is assessed on the lesser of undistributed net investment income or the amount of adjusted gross income ("A.G.I.") above a threshold amount, creating a dual system. Due to the dual system, there is a possibility that a trust or estate may not have taxable income, but may still have an N.I.I.T. liability. According to the I.R.S., this anomaly occurs because not all deductions a trust could use to eliminate its taxable income would be deductible under the N.I.I.T. regime. N.I.I.T. deductions are limited to specifically enumerated items.

Excess Deductions

Another anomaly occurs when a terminating trust allocates excess deductions but still has an N.I.I.T. liability. This result would ensue if a trust had non-N.I.I. expenses which were deductible in arriving at adjusted gross income, but would not be deductible against the N.I.I.T. while also having miscellaneous itemized deductions subject to the 2% floor. The N.I.I. would be higher than the A.G.I. because the non-N.I.I. expenses would not be deductible. When the 2% deductions are taken into account, both the N.I.I. and the trust's taxable income would be reduced, but the A.G.I. would not be, resulting in the possibility that the trust's N.I.I.T. and the A.G.I. would have two separate tax liabilities.

It is also possible to have an N.I.I.T. liability when it recovers a prior year deduction that is included in N.I.I. but not taken into account for taxable income purposes. This irregularity occurs if the trust/estate also has a large amount of miscellaneous itemized deductions. The 2% deductions may reduce N.I.I. and taxable income, but will not change the A.G.I. Consequently, the recovery would cause the N.I.I. to be calculated higher than the taxable income.

Allocating Expenses – Uniform Manner

The I.R.S. has signaled that trusts can allocate expenses to both N.I.I.T. and N.I.I. excluded income in any "reasonable manner." However, the I.R.S. asks practitioners to allocate expenses in the same uniform manner for regular income tax and for the N.I.I.T. The I.R.S. has indicated that practitioners cannot "re-do" their allocations for N.I.I.T. purposes. They must allocate expenses in the same manner for regular tax purposes as for N.I.I.T. purposes.

Usually, a practitioner desires to allocate expenses against the highest taxed income, but the practitioner may have high tax rate income that is excluded from net investment income. In that case, the practitioner might wish to allocate all the deductions to the N.I.I. for N.I.I.T. purposes, but not necessarily for regular tax purposes.

Material Participation

"Several recent court rulings have held that fiduciaries can rely on non-fiduciary activities to be active involvement in a business."

There is increased discussion as to whether a trust's income can be treated as non-passive/passive (and the N.I.I.T. can be avoided), when a trustee, acting in her fiduciary duty, has materially participated in a business. The issue is whether the material participation tests that are applied to individuals should apply for trusts and estates as well. The I.R.S. is concerned that this would make it "easier" for trusts and estates to qualify for material activity.

Although the I.R.S. only allows a trustee acting to carry out fiduciary duties to be deemed as material participation, several recent court rulings have held that fiduciaries can rely on non-fiduciary activities to be active involvement in a business. Therefore, it may be possible for trustees and executors to argue that he/she/it is materially participating through employees or agents, and that the trust or estate is not subject to the N.I.I.T.

Aggregation Allowed

Another divisive issue is whether a trustee can aggregate materially active house on all trusts, or whether a trustee will have to materially participate for 500 hours for each trust.

CERTIFYING THAT CONDUCT IS NON-WILLFUL IN STREAMLINED O.V.D.P MAY FACE ADDITIONAL RISKS

In general, the Offshore Voluntary Disclosure Program ("O.V.D.P") allows taxpayers to disclose overseas assets to the I.R.S. in exchange for a set penalty (currently 27.5%) and the chance to avoid criminal prosecution. In June, the agency unveiled streamlined procedures with a penalty of 0 to 5% for taxpayers who can certify that their conduct wasn't willful. Our firm reported about this change in our client advisory which can be read here.

The I.R.S. has advised that tax advisors should be wary when advising clients to certify that they were not willfully concealing funds overseas under the streamlined provision. The low penalty for non-willfulness may entice O.V.D.P participants to assert non-willfulness in all situations in a bid to obtain the low penalties. The I.R.S. has reminded practitioners of their responsibilities in this regard.

Taxpayers who enter the streamlined version of the O.V.D.P. have no relief from criminal prosecution. With the new change, a risk exists where the client may accuse the professional of counseling that the taxpayer had little risk of criminal prosecution, and nevertheless, the I.R.S. has decided to proceed with criminal prosecution against the taxpayer. Consequently, professionals should be wary of advising on “willfulness” and “non-willfulness.” Firms would be well served by developing a robust internal procedure to make determinations of willfulness versus non-willfulness for O.V.D.P. clients.

TRACKING SUBSTANTIAL PRESENCE – THERE’S AN APP FOR THAT

Recent advances in modern technology are enabling non-residents of the United States to avoid being overtaxed for their time spent abroad.

Non-residents of the United States must exercise caution when travelling to the U.S. at the risk of establishing a taxable presence in the country. Non-residents must track their stay in the United States in accordance to the I.R.S. Substantial Presence Test and, in New York, in accordance with the N.Y.S. and N.Y.C. Domiciliary and Statutory Residency Tests.

U.S. Residency

The I.R.S. establishes federal residency under the Substantial Presence Test by calculating the number of days a person has been in the U.S. and then attributing residency if the following criteria is met:

1. He or she has been present in the U.S. for at least 31 days of the current year, and

2. He or she was present in the U.S. for 183 days during a three-year period comprised of the current year and the two years directly prior, counting the days in the U.S. as follows:

    a. Each day present in the U.S. during the current year;

    b. 1/3 of the days present in the U.S. in the previous year; and

    c. 1/6 of the days present in the U.S. two years before the current year.

All individuals travelling abroad to the United States are required to file Form I-94 with the Department of Homeland Security, which enables the government to track a foreign individual’s stay in the country. Travelers are also given access to this information. By going on the website of the Department of Homeland Security, one can input their passport number, date of birth, social security number, and country of origin to view their travel history.

State Residency

In addition to the federal Substantial Presence Test, every state has its own rules for determining residency status. In New York State, for instance, to be considered a resident, one must have a domicile or a permanent place of abode in New York State.

As per the definitions set by the New York State Department of Taxation and Finance, a "domicile" is defined as:

- The place one has that is intended as a permanent home;
- The location of one's permanent home; and
- The place where one intends to return after a being away for any length of time.

A "permanent place of abode" is defined as:

- A place that one maintains, not contingent upon its usage; and
- A place that is equipped for use year-round.

Smartphone Application

Pursuant to the stringency of I.R.S. regulations for determining residency status for tax purposes, a smartphone application has been developed to enable non-U.S. residents to track their days in the U.S. The idea for the application, "Monaeo," was born in 2010 when co-developer Anupam Singhal started to file his tax returns and realized that he owed taxes to many jurisdictions and did not have an efficient way of tracking all his travels. Launched on January 12, 2012, this application provides users with a GPS-based tool to track their stay abroad down to the minute so as to avoid any unnecessary tax payments.

Potential misuse of the application can arise, however, when individuals track time spent in a location when they were not actually present there (*i.e.*, the smartphone travels but not the individual). Future versions of this application might necessitate a feature whereby the user must confirm his/her identity and location to start tracking days in the United States.