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INSIGHTS

U.K. DROPS CHANGES TO NON-DOMICILE REGIME, BUT LIKELY NOT FOR LONG

VALUE-ADDED TAX 101 – A FAR CRY FROM A BORDER TAX

CROSS-BORDER COMPLEXITIES: WHAT YOU NEED TO KNOW BEFORE YOUR NON-U.S. CLIENT INVESTS IN THE U.S.

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EDITORS' NOTE

In this month's edition of *Insights*, the following topics are addressed:

- **U.K. Drops Changes to Non-Domicile Regime, But Likely Not for Long.** After months of H.M.R.C. consultation, a new regime was put in place for non-domiciled U.K.-resident individuals ("Non-Doms") on April 6, 2017, only to see the legislation pulled from Finance Bill 2017 on April 25. The snap election in the U.K. put consideration of Non-Dom taxation on hold when 72 of the 135 clauses were removed from the bill. This allowed Parliament to approve the legislation in two hours. Gary Ashford of Harbottle Lewis, London, summarizes the short-lived provisions and those that failed to be enacted on April 6. The proposed regime remains a work in process, and enacting legislation could be back on the table as early as this fall.

- **Cross-Border Complexities: What You Need to Know Before Your Non-U.S. Client Invests in the U.S.** When foreign tax counsel advises a client on a personal investment in the U.S., it is common for a U.S. tax adviser to comment on the scope of U.S. income, gift, and estate taxes. Sometimes the investment is made through a trust and other times it is made directly. In their article, Kenneth Lobo and Fanny Karaman answer questions raised in the context of fact patterns often used.

- **Value-Added Tax 101 – A Far Cry from a Border Tax.** Although the U.S. is the world's largest economy, it is the only world economy that does not have a national value-added tax ("V.A.T."), and until the border adjustment tax ("B.A.T.") proposals were floated, most cross-border tax advisers in the U.S. needed only a vague concept of the workings of a national V.A.T. Fanny Karaman and Stanley C. Ruchelman explain the mechanics of the V.A.T. as enacted in the E.U., cautioning that the B.A.T. is not a V.A.T.

- **Tax Concerns on Outbound I.P. Transfers: Pitfalls & Planning in Light of I.R.S. Defeat in *Amazon* Case.** In the 21st century, the method of apportioning income from intangible property ("I.P."), between the various jurisdictions in which the I.P. is developed, owned, and used or consumed, is contentious. This was evidenced in a recent Tax Court case, *Amazon.com, Inc. & Subsidiaries v. Commr.*, which dealt with transfer pricing rules applicable to an outbound transfer of I.P. and a related cost sharing agreement. Philip R. Hirschfeld discusses the case in the context of Code §367(d), which relates to outbound transfers of I.P., and Treas. Reg. §1.482-7, which addresses qualified cost sharing agreements.

- **Valuation – More Art than Science.** In a recent case, the Tax Court was asked to evaluate two Old Masters paintings from the 17th century. Sotheby's provided the valuation for estate tax purposes on a gratuitous basis. The appraised value totaled $600,000 for the two works. The estate retained the same auction house to sell one of the paintings. The sale price at auction was $2.1 million before buyer's premium, and the auction took place within 34 months of the issuance of the appraisal report. Kenneth Lobo and Nina Krauthamer explain why the court had no difficulty finding that the estate's expert was not independent and that the subsequent sale was relevant.

- **How to Calculate Gain or Loss on Payables & Receivables Denominated in Nonfunctional Currency.** If currencies were pegged to a single standard and did not fluctuate in value among themselves, the concept of currency gain and loss would not be needed. However, no universal standard exists and major currencies tend to fluctuate. Consequently, a uniform method must be applied to identify the amount of a transaction when the conversion rate changes between a booking date and a payment date of a transaction denominated in a non-functional currency. In a recent International Practice Unit ("I.P.U."), the LB&I Division of the I.R.S. provides a broad overview of how currency gains and losses are recognized for U.S. tax purposes. Elizabeth V. Zanet and Stanley C. Ruchelman examine the applicable rules in the I.P.U.

- **Code §163(J) – Ignoring U.S. Thin Capitalization Rules May Leave Tax Advisors Thinly Prepared for Audits.** B.E.P.S. Action 4 focuses on the need to address base erosion and profit shifting using deductible payments, such as interest, that can give rise to double nontaxation in inbound and outbound investment scenarios. The U.S. addressed this problem many years ago with Code §163(j). In light of recent I.R.S. guidance providing a step-by-step plan to assist auditors when analyzing interest payments, non-U.S. practitioners should be aware of the thin capitalization debt rules when planning for multinational structures. Kenneth Lobo and Beate Erwin explain how the provision works in general and in several illustrative fact patterns.

- **Tax Home v. Abode – Are They the Same for Code §911 Purposes?** Code §911 provides certain tax benefits to persons who report foreign earned income. To be entitled to the benefits, an individual must have a "tax home" abroad, provided that he or she does not have an "abode" in the U.S. A recent summary opinion by the Tax Court illustrates the difference between those two terms. Rusudan Shervashidze and Philip R. Hirschfeld explain.

- **LB&I Audit Insights: Using a Code §6038A Summons When a U.S. Corporation is 25% Foreign Owned.** Code §6038A provides that a U.S. corporation that is 25% or more foreign-owned must provide the I.R.S. with information on certain transactions with its 25% foreign owner and any other foreign related party. The goal is to obtain access to documents that are helpful in determining the correctness of the U.S. tax return. In an I.P.U., LB&I explains how it plans to obtain documents held outside the U.S. This may include a requested exchange under a tax information exchange agreement or a summons served on a domestic agent appointed to receive a summons that is enforceable abroad. Galia Antebi and Stanley C. Ruchelman explain the process that will be followed by the I.R.S.

- **Updates & Tidbits.** Astrid Champion, Nina Krauthamer, and Jennifer Lapper look briefly at several timely issues, including (i) instructions for Form 8975, *Country-by-Country Report*, and Schedule A, *Tax Jurisdiction and Constituent Entity Information*, for U.S.-based multinationals, (ii) tax breaks for midsized companies in China, (iii) an executive order calling for review of all I.R.S. regulations issued in 2016, with a view to their withdrawal, and (iv) French Constitutional debate over penalties for nondisclosure of trust assets.

We hope you enjoy this issue.

- The Editors

U.K. DROPS CHANGES TO NON-DOMICILE REGIME, BUT LIKELY NOT FOR LONG

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Tags
Non-Dom
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U.K.

After months of H.M.R.C. consultation, it seemed a new regime for non-domiciled U.K.-resident individuals ("Non-Doms") was finally set to take effect on April 6, 2017. That was until the enacting legislation was suddenly pulled from Finance Bill 2017.

In an effort to hasten parliamentary approval ahead of the snap election on June 8, 2017, 72 of the 135 clauses were removed from Finance Bill 2017 on April 25, 2017. This allowed the Parliament to condense the customary two days of House of Commons debate, standing committee sessions, and an additional two days of report stage and third reading debate into a mere two hours.

The changes to Non-Dom taxation are the most significant since 2008 and follow a lengthy consultation period, during which several clarifications and modifications were made and numerous provisions were delayed as it was not possible to agree on final language. In many respects, this latest delay does not come as a surprise given the slow pace of the consultation process – for the portion dealing with trusts alone, the consultation period ran from December 5, 2016, to February 22, 2017.

Although the revised Non-Dom legislation has not been adopted, it is expected that the agreed-upon clauses, as outlined below, will appear in a later bill. Subject to the election result, enacting legislation could be passed as early as this fall with effect from April 6, 2017, upon enactment. Other proposed changes, which were delayed prior to the parliamentary vote, may be adopted in a later finance bill, presumably Finance Bill 2018.

DEEMED DOMICILE

The main revisions call for individuals who are not actually domiciled in the U.K. to be deemed domiciled for all U.K. tax purposes if either of the following fact patterns apply:

- They have been resident in the U.K. for 15 of the previous 20 tax years (the "15/20 Rule").
- They were born in the U.K. with a U.K. domicile of origin and they are resident in the U.K.

Under the revised regime, U.K.-resident Non-Doms who fall into either of the above categories will lose the opportunity to claim the remittance basis of taxation and will be subject to tax on worldwide income and gains from April 6, 2017. The pre-existing rule – under which Non-Doms who have been resident in the U.K. for 17 of the previous 20 tax years (the "17/20 Rule") are deemed to be U.K. resident for inheritance tax purposes – will all be aligned to the 15/20 Rule.

CAPITAL GAINS TAX REBASING

Non-Doms who become deemed domiciled on April 6, 2017, under the 15/20 Rule will be afforded some relief from capital gains tax on pre-existing gains through a step-up in basis to the value of the assets as of April 5, 2017. This relief will be available only to those who at some point prior to April 6, 2017, prepared tax returns under the remittance basis and paid the remittance basis charge ("R.B.C."). Non-Doms who have never paid the R.B.C. will be required to do so during the 2016-2017 tax year in order to benefit from the step-up in basis. The tax return deadline for claiming remittance basis tax and paying R.B.C. is January 31, 2018.

Certain limitations apply to Non-Doms wishing to benefit from the step-up in basis. First, the step-up in basis will be available only to assets owned as of March 16, 2016, that have been treated as being located outside the U.K. at all time through April 5, 2017. Second, Non-Doms born in the U.K. and having a U.K. domicile of origin cannot access this relief.

CLEAN UP OF MIXED FUNDS

U.K.-resident Non-Doms will also be given the opportunity to reorganize their non-U.K. bank accounts containing mixed funds. In anticipation of the enactment, many clients may want to consider splitting out such funds into separate accounts to facilitate tax-efficient remittances to the U.K. Under the agreed-upon clauses, the separation must be completed it prior to April 5, 2019.

This opportunity will be open to Non-Doms whether or not they become deemed domiciled on April 6, 2017. However, they must have reported income under the remittance basis of taxation at some point prior to the April 6, 2017, cutoff and, where appropriate, paid the R.B.C. As with many of the proposed changes, U.K.-resident Non-Doms who were born in the U.K. with a U.K. domicile of origin will not have the opportunity to cleanse mixed funds.

The Spring 2017 Budget included a statement that the opportunity to separate mixed funds will cover years ending prior to April 6, 2008. However, language to that effect was not part of draft legislation. A correction is expected post-election.

As of April 6, 2017, a new "Requirement to Correct" offense will also be instituted. If noncompliance in an earlier year is identified when undertaking the clean up a mixed fund, an obligation to correct likely will be imposed on the U.K.-resident Non-Dom, perhaps by way of a disclosure to H.M.R.C.

PROTECTION FOR NON-DOM SETTLORS

During the consulation process, various transitional rules were proposed to potentially soften the introduction of the revised Non-Dom regime.[1] These included protections for individuals becoming deemed domiciled on April 6, 2017, who set up nonresident trusts prior to becoming deemed domiciled.

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1 For more information, see Gary Ashford, "U.K. Non-Dom Taxation – Where it is and Where it is Going," *Insights* 10 (2015); see also Gary Ashford, "Further Developments for U.K. Non-Dom Individuals," *Insights* 9 (2016).

H.M.R.C. set out the first draft legislation on December 5, 2016, within the draft Finance Bill 2017. However, it was not until January 27, 2017, that H.M.R.C. published draft legislation regarding income tax, including the proposed amendments to the Transfer of Assets Abroad ("T.O.A.A.") legislation.

In general, U.K.-resident and domiciled settlors holding an interest in an overseas trust are taxed on all capital gains within the trust on an arising basis. The current rules exclude Non-Dom settlors. Therefore, they are taxed under the rules for beneficiaries, which provide only for taxation in relation to distributions, matched to any gains within the trust. Under these provisions, a Non-Dom has the opportunity to apply the remittance basis to limit any tax on gains resulting from U.K.-situs assets or overseas gains to the extent remitted to the U.K. Without the proposed protections, Non-Doms who become deemed domiciled on April 6, 2017, will become liable to tax on all capital gains arising in any trust, in the same way as U.K.-resident and domiciled settlors.

"The changes will effectively prohibit a widely-used planning strategy whereby a Non-Dom buys a U.K. home through a foreign company so as to remain outside of the U.K. inheritance tax net."

The transitional rule will prevent a deemed domiciled Non-Dom from being taxed on an arising basis and will defer taxation of capital gains to the time of distribution, without further benefit under a remittance rule. Note that the transitional rule will not be available to any Non-Dom who is deemed U.K. domiciled by virtue of being born in the U.K. with a U.K. domicile of origin. Those individuals will be taxable on all capital gains that arise within a trust.

Under the current regime, the pot of capital gains available to be matched can be reduced through certain methods, including capital payments made to nonresident or temporary nonresident beneficiaries and distributions linked to the cessation of the trust where at least one of the recipient beneficiaries is a nonresident. Attempts to limit the scope of these planning opportunities were not part of the final legislation. If enacted, these limitations will not come into effect before April 6, 2018, thereby providing taxpayers with additional time before the full impact is realized.

Additionally, where distributions are made to a beneficiary who is a close family member (*e.g.*, a spouse, civil partner, or minor child) that is a nonresident with regard to the U.K., or is a Non-Dom U.K.-resident reporting income on the remittance basis, tax will be imposed on the deemed domiciled settlor if the gains are not remitted to the U.K.

Where the settlement legislation applies, the settlor will be taxed on the income of the trust on an arising basis. This treatment is subject to transitional relief. If a trust is set up before the settlor becomes deemed domiciled and no further contributions of property are made to the trust, the settlor will be taxed in the year a distribution is received, not when it arises in the trust. Similar treatment is provided where a close family member receives a benefit from the trust. Relief under the transitional rule will not be extended to individuals who become deemed domiciled due to having been born in the U.K. with a U.K. domicile of origin.

It is expected that the T.O.A.A. rules will be amended to align with the protected income rules found in the settlements legislation, but only if included in Finance Bill 2018.

RESIDENTIAL PROPERTY AND INHERITANCE TAX

The draft legislation within Finance Bill 2017 stated that property would not be excluded property for inheritance tax purposes in a number of cases where the value is directly or indirectly attributable to U.K. residential property. Thus, where a nonresident entity owns U.K. real property, the interest in that entity will be subject to inheritance tax upon the death of the interest holders.

Interest covered by this rule includes (i) a right or an interest of more than 1% in a close company, (ii) an interest in a partnership, or (iii) an interest in a debt instrument that is a relevant "relevant loans." In this context, a relevant loan is a loan used to directly or indirectly finance the acquisition, maintenance, or enhancement of, or to procure a right to acquire, maintain, or enhance, U.K. residential property. A relevant loan is also one used to acquire an interest in a close company to the extent that the loan finance is used to acquire, maintain, or enhance U.K. residential property. The changes will effectively prohibit a widely-used planning strategy whereby a Non-Dom buys a U.K. home through a foreign company so as to remain outside of the U.K. inheritance tax net.

Many clients have been reviewing these structures in recent months, as in some cases, under the new rules, no benefit remains in using a company for this purpose, particularly in light of the annual costs and taxes. Instead, many have decided to "de-envelope" their U.K. property so that it is held personally. De-enveloping may likely be subject to significant costs, such as capital gains tax and stamp duty land tax charges. Nonetheless, in light of the political stance being taken by H.M.R.C. on offshore structures, de-enveloping may be worth the cost.

In computing value for inheritance tax purposes, debt will remain deductible after the April 6, 2017, effective date. However, offsetting it against a property's value to potentially reduce the attributable value for inheritance tax purposes may bring added complications, in that the loan will be subject to inheritance tax within the estate of the lender. This may, of course, discourage lenders from making such loans and would certainly introduce significant complexity into arrangements involving loans.

BUSINESS INVESTMENT RELIEF

To date, no draft legislation has been published in relation to the revised rules for business investment relief ("B.I.R."), however the issue is likely to resurface post election.

B.I.R., in its current form, was introduced on April 6, 2012. The purpose of this relief is to allow U.K.-resident Non-Doms who have claimed the remittance basis to bring foreign income or gains to the U.K. for investment in a targeted company without triggering the R.B.C. The investment can be made in the form of money or other property derived from foreign income and gains, or in the form of shares or a loan to the target company, so long as it originates from years in which a person was taxed on the remittance basis.

Several conditions must be met to benefit from B.I.R.:

- The investment must be a qualifying investment.
- It must be made in a target company within 45 days from the date funds are brought to the U.K.
- B.I.R. must be claimed on a self-assessment tax return.

Investments are qualifying investments where two conditions are met:

- The target company must be (i) an eligible trading company, (ii) an eligible stakeholder company, or (iii) an eligible holding company.
- No relevant person receives any benefit directly or indirectly from the target company or any company associated with it, whether or not the benefit is connected to the investment.

In terms of the first condition, qualifying companies are those that carry on a trade or generate income from land (including property), make investments into such companies, or hold shares in such companies. Note that a start-up period is allowed before a commercial trade is first carried on. Under prior law, the start-up period was capped at two years.

Under the revised regime, the cap on the start-up period will be expanded to five years, effective April 6, 2017. The new rules will extend the definition of a qualifying investment to include the acquisition of both existing shares and new shares in qualifying target companies. It will also clarify that the corporation must carry on trading activities itself. Activities of partnerships will not qualify for B.I.R.

When a company ceases its commercial operations, the investment of the U.K.-resident Non-Dom must be removed from the U.K. within a short period of time, which can be as little as 45 days. The changes to B.I.R. will extend the period for removal of funds so that it may be as long as two years from the date upon which the investor becomes aware of the cessation of trading activities.

LEGISLATION TO BE PUBLISHED IN A FUTURE FINANCE BILL

As previously mentioned, various proposals were delayed prior to the parliamentary vote on April 25, 2017. It is expected that H.M.R.C. will publish further draft legislation to address open items, presumably in Finance Bill 2018. A summary of the anticipated legislation is set out below.

<u>Computation of Capital Gains Tax on U.K. Deemed Domiciled Settlors of Foreign Trusts on the Arising Basis, T.C.G.A., Schedule 5</u>

- Disregard of §87 capital payments to nonresidents in connection with gains realized by foreign trusts with the effect that the gains are taxed to the settlor
- Disregard of §87 capital payments to migrating beneficiaries in connection with gains realized by foreign trusts with the effect that the gains are taxed to the settlor
- Transfer of §87 benefits charged to the settlor where the beneficiary is a close family member of the settlor and is not liable to capital gains tax on the payment in connection with gains realized by foreign trusts
- Attribution of gains to recipients of onward gifts (recycling rule)

<u>Chapter 5 of Part 5 of I.T.T.O.I.A. (Settlements)</u>

- Benefits charge for foreign domiciled settlors and deemed domiciled settlors in respect of benefits received by the settlor or close family member such as a spouse, cohabitee, or minor child (not including a minor grandchild)

- Benefits charge on settlor when beneficiary receiving benefits is close family member but is not taxable on the benefit
- Attribution of deemed income to a U.K.-resident recipient of a gift when a trust having income makes payments to nonresidents or remittance basis users who hold the money for a period of time before giving or lending it back to a beneficiary in the U.K. (tracing to stop when more than three years lapse between distribution and gift)

One question that remains is whether future legislative action on these items will be effective as of April 6, 2017.

CONCLUSION

For the time being, the U.K. Non-Dom rules live on in full force. However, subject to the result of the snap election, the revised provisions will likely be enacted within the year. While the changes slated for April 6, 2017, limit some of the opportunities provided by the Non-Dom regime, the remaining opportunities will still be quite significant. As has been the case since April 2008, arriving U.K.-resident Non-Doms will have seven years of access to the remittance basis regime with no cost. Thereafter, the R.B.C. will remain at £30,000 until the individual has been resident for 12 years, after which point it will increase to £60,000. The main changes to the legislation are focused on long-term residents (soon to be 15 years) and those born in the U.K. with a U.K. domicile of origin.

"This delay affords clients a unique opportunity: additional time to plan for the past."

Clients who would become deemed domiciled on April 6, 2017, should review their investments and, where appropriate, segregate those made before April 6, 2017, from those made after April 6, 2017. Consideration should also be given to investments that defer the point of taxation, such as bonds, equities, or funds. Consideration should be given to the impact of rebasing, whether positive or negative, and action taken accordingly.

B.I.R. remains a very attractive option and will become even more attractive going forward. For those who would become deemed domiciled on April 6, 2017, the soft landing provided by a step-up in tax basis and the two-year window in which to clean up mixed funds will be helpful. Non-Doms will be able to revisit their investments and potentially identify and extract or use clean capital in a variety of imaginative ways. In cases where it would be practically difficult to clean up a mixed fund, B.I.R. may allow such funds to be used in the U.K. without triggering an R.B.C.

In light of recent political shifts, the U.K. government is keen to make known to the world that the U.K. – and particularly the Non-Dom regime – is very much "open for business" and will remain so for newly arriving individuals not having been born in the U.K. with a U.K. domicile of origin. This delay affords clients a unique opportunity: additional time to plan for the past.

CROSS-BORDER COMPLEXITIES: WHAT YOU NEED TO KNOW BEFORE YOUR NON-U.S. CLIENT INVESTS IN THE U.S.

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Tags
Foreign Investment
Trusts
Estate and Gift Tax

INTRODUCTION

Tax planners outside the U.S. are often asked to develop plans for clients moving to or investing in the U.S. While these plans are effective in the client's country of residence, adverse U.S. tax consequences may arise in ways that are not anticipated.

These problematic situations may include (i) the purchase of U.S. real property using a trust that is tax efficient in the home country but produces suboptimal results from a U.S. tax perspective or (ii) the sudden appearance of a U.S. resident within the family of the foreign client, among other complications. These situations sometimes result in substantial penalties for the client or the family member that is a U.S. tax resident.

The following questions and answers address fact patterns that are commonly are encountered. Some involve use of a trust and others involve gift and estate tax exposures that may be unexpected.

CREATING A TRUST

Question 1: My client and his family are moving from Country A to the U.S. I arranged the formation of a trust to hold certain assets. Will the income within the trust affect the U.S. tax liability of the client or family members?

Yes. The client may face U.S. income tax, estate tax, and gift tax issues in connection with the trust previously formed.

The answer will depend on (i) whether the trust is foreign or domestic for U.S. income tax purposes, (ii) whether the trust is a grantor or nongrantor trust, (iii) whether the trust is revocable or irrevocable, (iv) the tax residence or citizenship of the beneficiaries, (v) the investments held in trust, and (vi) the pattern of trust distributions among beneficiaries in earlier years.

Foreign v. Domestic Trusts

Question 2: The sole trustee of the trust is a Country A national and the trust contains no provision for a protector. All the assets will be in the U.S. Will the trust be considered to be a foreign trust for U.S. income tax purposes?

Yes. Under U.S. tax law, a foreign trust is defined to be any trust that is not a "domestic trust."[1]

For a trust to be a domestic trust, two tests must be met. First, a U.S. court must

[1] Code §7701(a)(31)(B).

exercise primary supervision over the trust's administration (the "court test"). Second, one or more U.S. persons must have the authority to control all substantial decisions affecting the trust (the "control test").[2]

To satisfy the court test, three conditions must be met. First, the trust instrument must not direct that the trust be administered outside the U.S. Second, the trust must actually be administered exclusively in the U.S. Third, the trust indenture cannot contain an automatic migration provision whereby the trust could migrate from the U.S. if a U.S. court attempts to assert jurisdiction over the trust.[3] Interestingly, the third condition is not violated by a provision calling for automatic migration of the trust from the U.S. in the case of foreign invasion of the U.S. or widespread confiscation or nationalization of property in the U.S.

Regarding the control test, two terms must be defined: "control" and "substantial decisions." Control means having the power, by vote or otherwise, to make a decision regarding the trust, with no other person having the power to veto that decision.[4] To determine whether U.S. persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

If the sole trustee is a Country A national, your client's trust likely does not satisfy the control test.

Question 3: I altered the trust for my Country A clients. Now, a U.S. court has primary supervision over the trust and there are two trustees who must act in unanimity: one is a Country A citizen and resident, and one is an American citizen. Is the trust a U.S. trust?

No. The control test is met only if one or more U.S. persons have the authority to control all substantial decisions.

As previously mentioned, control means having the power, by vote or otherwise, to make a decision regarding the trust, with no other person having the power to veto that decision.[5] If more than one trustee exists and the trustees must act by unanimity, the presence of a non-U.S. person as one trustee will prevent the trust from meeting the control test.[6]

Question 4: What decisions are considered to be substantial decisions for purposes of determining the status of the trust for U.S. tax purposes?

The regulations provide examples of decisions that are considered substantial for purposes of the control test. These include, but are not limited to, the following:

- Whether and when to distribute income or corpus
- The amount of any distributions
- The selection of a beneficiary

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[2] Code §7701(a)(30)(E).

[3] Treas. Reg. §301.7701-7(c)(4)(ii).

[4] Treas. Reg. §301.7701-7(d)(1)(iii).

[5] Treas. Reg. §301.7701-7(d)(1)(iii).

[6] Treas. Reg. §301.7701-7(d)(1)(v), ex. 1.

“A grantor trust generally will be disregarded for U.S. income tax purposes and the grantor will be considered the owner of the trust assets and of the trust income.”

- Whether a receipt is allocable to income or principal
- Whether to terminate the trust
- Whether to compromise, arbitrate, or abandon claims of the trust
- Whether to sue on behalf of the trust or to defend suits against the trust
- Whether to remove, add, or replace a trustee
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from non-U.S. to domestic or vice versa
- Investment decisions

Note that if a U.S. person under Code §7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by a U.S. person if the U.S. person can terminate the investment advisor's power to make investment decisions at will.[7]

Question 5: What decisions are not substantial decisions?

The regulations provide that the following decisions are ministerial and not substantial:

- Bookkeeping
- Collection of rents
- Execution of investment decisions[8]

Grantor v. Nongrantor Trusts

Question 6: My Country A client settled a trust under New York State law. I understand that U.S. tax law provides one type of treatment for trusts referred to as “grantor trusts” and a different type of treatment for trusts referred to as “non-grantor trusts.” What is the difference?

A nongrantor trust is treated as the taxpayer and, as such, is taxable on trust income. In comparison, a grantor trust generally will be disregarded for U.S. income tax purposes and the grantor will be considered the owner of the trust assets and of the trust income.

In the case of a nongrantor trust, the trust is taxed on the trust's income but is allowed a deduction for all amounts that are actually distributed during the year and certain amounts that are distributed within the first 65 days of the following taxable year, provided that an election is timely made on the tax return of the trust.[9]

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7 Treas. Reg. §301.7701-7(d)(1)(ii).

8 *Id.*

9 Code §663(b); Treas. Reg. §1.663(b)-2(a).

The includible amount (and the deduction) are limited by distributable net income ("D.N.I.").[10] The beneficiary will include the distribution in his taxable income and the distributed income will have the same character in the hands of the beneficiary as it had in the hands of the trust.[11]

In the case of a grantor trust, the "grantor" (*i.e.*, the person who gratuitously transferred the assets to the trust) is considered the taxpayer.[12] As a result, distributions from a grantor trust are generally treated as gifts from the grantor for substantive income tax purposes. Nonetheless, if the grantor trust is a foreign trust, the beneficiary reports the distribution as a distribution solely for information reporting purposes.[13]

Question 7: I've recommended a tax plan where my Country A client will be transferring assets into a trust. His children and a charity will be the beneficiaries. The trust is irrevocable. Is the trust a grantor trust or a nongrantor trust?

In your client's case, the trust is a nongrantor trust.

For U.S. tax purposes, a trust that has a non-U.S. person as grantor can qualify as a grantor trust in two situations.[14] In the first situation, a non-U.S. person makes a gratuitous transfer of assets to the trust but retains the right to revoke the trust and to be revested absolutely in the title to the property.[15] The right of revocation must be exercisable at his or her sole discretion and without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor. The non-U.S. person must be able to exercise this power on at least 183 days during the taxable year.[16] In the second situation, a non-U.S. person makes a gratuitous transfer of assets to the trust and the only amounts distributable from the trust during the life of the grantor are to the grantor or the grantor's spouse.[17]

Neither exception applies here. The trust is irrevocable and the beneficiaries include persons other than the grantor or the grantor's spouse.

Question 8: I've drafted a trust for my client that is grantor trust from a U.S. tax perspective. My client is the grantor of the trust and is a citizen and resident of Country A. The trust is revocable by my client without the approval or consent of any other person. The trust has now made a distribution to a U.S. beneficiary. Must any information be reported to the I.R.S.?

Yes. The distribution should be reported by the U.S. beneficiary on Part III of Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of*

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10 Code §661.

11 Code §§652 or 662.

12 Code §671. A trust can be a grantor trust for some its income and assets and a foreign nongrantor trust for other assets and income.

13 2016 Instructions for Form 3520, p. 13.

14 Code §672(f).

15 Code §672(f)(2)(A)(i).

16 Treas. Reg. §1.672(f)-3(a)(2).

17 Code §672(f)(2)(A)(ii).

Certain Foreign Gifts.[18] In addition, a Foreign Nongrantor Trust Beneficiary Statement should be provided to the U.S. beneficiary. In this case, a Foreign Grantor Trust Beneficiary Statement appears to be inappropriate because there is no U.S. person that transferred assets to the trust.

The Foreign Nongrantor Trust Beneficiary Statement must include the following items:

- An explanation of the appropriate U.S. tax treatment of the distribution or sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of the distribution for U.S. tax purposes
- A statement identifying whether any grantor of the trust is a partnership or a foreign corporation
- A statement that the trust will permit either the I.R.S. or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records, and other documents necessary to establish the appropriate treatment of any distribution for U.S. tax purposes
- The first and last day of the tax year of the foreign trust
- A description of property (including cash) distributed to the U.S. beneficiary during the tax year, and the fair market value of the property distributed
- A statement as to whether the foreign trust has appointed a U.S. agent and the name, address, and taxpayer identification number of any such agent

"Once the D.N.I. and U.N.I. is fully distributed, the balance of a distribution may be treated as tax-free capital."

Question 9: My client is a Country A national and has a trust for the benefit of his spouse and children. The trust owns several apartment buildings in Country B that generate rental income. The rents have been retained in the trust. One of my client's children moved to the U.S. several years ago and is now in the process of becoming a U.S. citizen. Can this result in adverse U.S. tax consequences?

Yes. The problem that will adversely affect the U.S. beneficiary relates to the accumulation of income within the trust and its potential distribution at a future point.

If a non-U.S. trust generates and accumulates its D.N.I., the retained D.N.I. is converted into undistributed net income ("U.N.I."). Should the trust ever make a distribution that exceeds D.N.I. for that year, the excess amount will be treated as a distribution made from U.N.I. Distributions from U.N.I. are taxed under a "throwback rule" that allocates the distributed U.N.I. to prior years under a formula.[19] An average increase in taxes allocated to the years covered by the throwback computation and interest charges from deemed late payments of U.S. tax for those years is imposed. In addition, all capital gain items that have not been distributed on a current basis lose their character as capital gains and do not benefit from favorable tax rates for long-term capital gains and qualified dividends. In addition to income tax, net investment income tax of 3.8% may be imposed.

Note that the tax cannot be eliminated by having the trustee treat the distribution as

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[18] See p. 10 of the Instructions for Form 3520 for tax year 2016.

[19] See Code §§665-668.

a capital distribution. All distributions are deemed to consist of (i) income and gains and (ii) D.N.I. and U.N.I. of the trust on a *pro rata* basis.[20] Once the D.N.I. and U.N.I. is fully distributed, the balance of a distribution may be treated as tax-free capital.

U.S. ESTATE & GIFT TAX

Question 10: My Country A client has executed a will, and his estate will be left to his son who is a U.S. person. All property owned by my Country A client is located in Country A. Will the U.S. son be subject to inheritance tax on his receipt of the bequest?

No. The estate tax in the U.S. is imposed on the estate of the decedent. The taxable estate of an individual decedent who is neither a citizen nor a resident of the U.S. is computed generally by taking into account only items connected with the U.S. This limitation in scope affects both assets included in the gross estates and liabilities and costs that reduce the estate. First, U.S. estate tax is generally imposed only with regard to items of U.S.-situs property.[21] Examples of such property include real estate located in the U.S., debt instruments (other than debt having the character of portfolio debt) and shares of stock issued by U.S. companies, and personal property located in the U.S. at the time of the decedent's death.[22]

As a general rule, indirect ownership of U.S.-situs assets is not sufficient to expose the estate of a nondomiciled, non-citizen individual to U.S. estate tax. Thus, no tax is imposed when a foreign individual owns shares of stock of a foreign corporation that, in turn, owns U.S.-situs property such as shares of stock in a U.S. corporation.

Second, the amount of funeral expenses, administration expenses, claims against the estate, and unpaid mortgages that may be applied to reduce the gross estate in the U.S. is limited to a percentage, which is based on the portion of the worldwide estate that is located in the U.S.[23] A true and accurate accounting must be made in the U.S. estate tax return of the worldwide assets of the decedent. If not made, no portion of the expenses, losses, indebtedness, and taxes may reduce the gross estate.[24]

Here, your client owns property only in Country A. Should the estate be comprised of such property exclusively, the U.S. son will not be subject to U.S. estate tax or income tax upon the receipt.[25] However, the U.S. son is obligated to report the inheritance to the I.R.S. as a form of anti-money laundering compliance. The report is made on Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*. A penalty may be imposed of up to 25% of the amount that goes unreported.

Question 11: My client proposes to leave all his property in Country A and elsewhere to his daughter, who is in the process of obtaining U.S. citizenship.

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[20] Code §662(a)(2).

[21] Code §2103.

[22] Treas. Reg. §20.2104-1

[23] Code §2106(a).

[24] Treas. Reg. §20.2106-2(a).

[25] Code §6039F.

After his daughter receives the property, will that property be subject to estate tax at the conclusion of the daughter's lifetime?

Yes. All property owned at the time of death by (i) U.S. citizens and (ii) non-U.S. citizen individuals domiciled in the U.S. is subject to U.S. estate tax no matter where located.

The estate may be reduced by funeral and administration expenses, indebtedness, and claims against the estate.[26] In addition, U.S. tax law allows a credit that is the equivalent of a lifetime gift tax and estate tax exemption for individuals. For 2017, the exemption amount is U.S. $5.49 million.[27] Cumulative lifetime taxable gifts are added to the taxable estate to unify the gift and estate tax system.[28]

Married couples may combine the exemptions so that if the first spouse to die owns insubstantial assets, the unused exemption may be claimed at the time of death of the survivor.[29]

If the surviving spouse is a U.S. citizen, a decedent who is a U.S. citizen, or who is domiciled in the U.S., is entitled to an unlimited marital deduction for amounts bequeathed to the spouse.[30] If the surviving spouse is not a U.S. citizen, the deduction is allowed only if the property is transferred to a qualified domestic trust.[31]

If the property is located outside the U.S., a foreign tax credit may be claimed for the amount of any estate, inheritance, legacy, or succession taxes actually paid to another jurisdiction in respect of any property situated within that country and included in the gross estate of the decedent under foreign law.[32]

Here, your client's daughter will be subject to the U.S. estate tax on her worldwide estate at the conclusion of her lifetime. A foreign tax credit may be claimed for any estate tax actually paid to Country A.[33]

Question 12: My client has acquired a condominium in Florida where he intends to spend several months each year. The balance of time will be spent in Country A, in the family home. He is concerned that he will become a resident of the U.S. for estate tax purposes. Is his concern well grounded?

No. The U.S. estate tax rules differ from the U.S. income tax rules. For income tax purposes, residence is based on objective factors such as the number of days present in the U.S. or the issuance of a permanent resident visa. In comparison, residence for estate tax purposes is based on concepts of domicile.

A person acquires a domicile in a place by living there, for even a brief period of time, without the presence of a definite intention to leave. A facts and circumstances test is used to determine domicile. Generally, permanent residents ("green card

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26 Code §2053(a)

27 Rev. Proc. 2016-55.

28 Code §2001(b)(1)(B).

29 Code §2010(c)(5)(A).

30 Code §2056

31 Code §2056(d).

32 Code §2014.

33 Code §2014.

holders") are presumed to be U.S. domiciliaries unless facts show otherwise.

Here, the absence of a permanent resident visa and continued availability of a permanent residence in Country A suggests that your client will not be domiciled in the U.S. This conclusion assumes that contacts in the U.S. are limited to the facts described.

Question 13: My client owns a condominium in New York in his own name. At the conclusion of his lifetime, will U.S. estate tax be imposed on the condominium?

Yes. The condominium is an item of U.S.-situs real property as it is considered to be real property under New York State law. The condominium and all belongings located in it will be included in a U.S. taxable estate.

Question 14: Will the answer change if my client transfers the U.S. property to a discretionary, irrevocable trust for the benefit of himself, his spouse, and his son?

No. In some instances, property not legally owned at the conclusion of lifetime may be included in a taxable estate.

For this to occur, the decedent must have transferred property during his or her lifetime but retained sufficient interest or control over the transferred assets for the remainder of his life or for any period not ascertainable without reference to his death. An asset will be included in a taxable estate if the decedent retained the possession or enjoyment of, or the right to the income from, the property.[34] Also included are assets that the decedent transferred during life but with regard to which the decedent had the power to alter, amend, revoke, or terminate the enjoyment of the property through retained powers.[35] This rule applies to a revocable or amendable trust.

Although not specifically asked, it should also be noted that the transfer of the U.S. condominium to the irrevocable trust will give rise to gift tax because a condominium unit generally is viewed to be real property. When determining estate tax, a credit against estate tax due is allowed for previously paid gift tax.[36]

Question 15: My client is a Country A national. He is the sole shareholder of a U.S. company that is valued at $25 million. His only child is his daughter, who has studied in the U.S. and is now in the process of becoming a U.S. citizen. I am concerned about the U.S. estate tax, and so, I advised my client to transfer the shares to a trust for the benefit of his daughter. The father will not have right to income, but he will be the sole trustee of the trust and can vote the stock of the U.S. corporation. Will the assets be included in his estate?

Yes. Although the shares have been given away absolutely, the right to vote stock of a controlled corporation will result in exposure to estate tax.[37] Control is the retention of 20% of the combined voting power of all shares entitled to vote.[38]

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[34] Code §2036(a)(1).

[35] Code §2038.

[36] Code §§2102, and 2012.

[37] Code §2036(b)(1).

[38] Code §§2036(b)(2) and 318.

Question 16: My Country A client's spouse passed away. The spouse's U.S.-situs property was transferred into an irrevocable trust. The trust provides that after the grantor's death, my client was entitled to the trust income and that he could appoint the income and trust assets however he saw fit. I was advised that my client may have a U.S. estate tax exposure. Is this correct?

Yes. If a non-U.S. decedent holds a general power of appointment at the conclusion of her lifetime, the trust's U.S. assets will be included in the decedent's U.S. taxable estate unless an exception applies. A general power of appointment exists if a power is exercisable in favor of the decedent, her estate, her creditors, or the creditors of her estate.[39]

Question 17: My client is a Country A national and purchased a New York City condominium for $10 million. As she is worried about the U.S. estate tax, she wants to transfer the U.S. real property to her daughter, who is also a Country A national and resident and not a U.S. person. Will this transfer be free of tax in the U.S.?

No. U.S. gift tax applies to a noncitizen, non-resident individual who transfers U.S.-situs property that constitutes either real property or tangible personal property.[40] The condominium is real property under New York State law. Hence, the gift is subject to gift tax.

Question 18: My Country A client formed a U.S. corporation to own a condominium. He is concerned that the shares of the U.S. corporation will be subject to U.S. estate tax. He proposes transferring the shares of the U.S. corporation to a Country A corporation in a tax-free transfer covered by Code §351 or Code §368(a)(1)(B). He will own all the shares of the transferee. Will that insulate my client from U.S. estate tax?

No. U.S. law contains anti-inversion rules[41] that prevent shareholders of a U.S. corporation from benefitting when the corporation's assets are directly or indirectly transferred to a foreign corporation that is at least 80%-owned by stockholders of the U.S. corporation. The foreign corporation is treated as a U.S. corporation for all purposes of U.S. tax law. Here, it is proposed that the sole shareholder of the U.S. corporation will become the sole shareholder of the Country A corporation. This is an indirect transfer of assets by the U.S. corporation. Consequently, the Country A corporation is treated as a U.S. corporation, and the U.S. estate tax exposure continues.

Question 19: My Country A client also owns shares of Apple valued at $7 million. Is there an exception for intangible property under the U.S. estate tax as there is for U.S. gift tax?

No. The exception for intangible property under the U.S. gift tax regime does not apply to the U.S. estate tax regime. Your client's Apple shares will be included in his U.S. taxable estate at the conclusion of his life.

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39 Code §2041(b).

40 Code §2511(a).

41 Code §7874.

VALUE-ADDED TAX 101 – A FAR CRY FROM A BORDER TAX

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Tags
Border Adjustment Tax
Tax Reform
Value-Added Tax

INTRODUCTION

Although the U.S. is the world's largest economy, it is the only world economy that does not have a value-added tax ("V.A.T."). While most U.S. states impose state sales and use taxes to fund state and local governments, those taxes are imposed at much lower rates than the V.A.T. found in Europe. On the other hand, all world economies, including the U.S., have a corporate income tax. As a result, the U.S. is viewed to have attractive tax features because it competes with economies that raise revenue from both corporate income tax and V.A.T. – with V.A.T. often being the major source of revenue for national governments. Ongoing discussions about a potential repeal of the U.S. corporate income tax on exports and implementation of a U.S. border adjustment tax on imports have suggested that similarities exist with a V.A.T.

While both provide exemption for exports and taxation of imports, the border adjustment tax, as currently proposed, is a far cry from a V.A.T. Whether the two systems ultimately align will depend on the final version of the border adjustment tax, whenever enacted. For those who ponder on possible similarities, this article provides a baseline of comparison – it summarizes the V.A.T. mechanism drafted at the E.U. level.

V.A.T. OVERVIEW

Nature of a V.A.T.

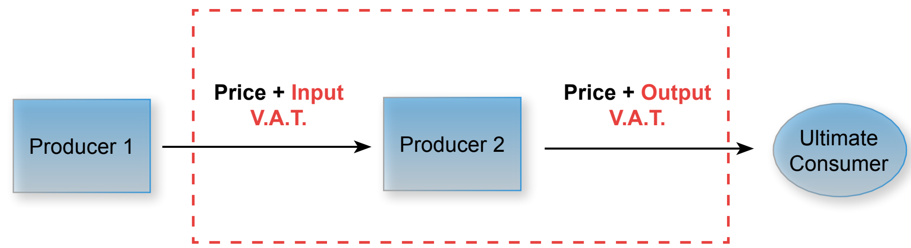
Countries worldwide generally have the choice among four revenue-raising categories of taxation: income, wealth, wages, and consumption. A V.A.T. is a tax on consumption.

It is a tax on the value that every economic agent ("Taxable Person") in a given production and distribution chain adds to the produced good or the provided service. Upon the sale of that good or service, whether to the next Taxable Person in the production and distribution chain or to the final customer, a Taxable Person must collect V.A.T. from the purchaser at the applicable rate imposed on the value of the transaction. Because the person subject to the V.A.T. is the Taxable Person and because that Taxable Person collects the tax from the purchaser (as opposed to incurring it itself), a V.A.T. is referred to as an "indirect tax." As explained in further detail below, the Taxable Person is responsible for collecting V.A.T. and paying it to the relevant tax authorities. Such payment is referred to as a "remittance." The tax base is generally the value added by a given Taxable Person to the good or service – hence the name "value-added tax." In all V.A.T. systems, a mechanism must exist to prevent multiple levels of taxation as a product proceeds through a production and distribution chain.

Input V.A.T. v. Output V.A.T.

In a given production and distribution chain, a taxable person generally pays V.A.T. on goods and services purchased for its trade or business, and collects V.A.T. on goods or services sold in its trade or business. The V.A.T. that is collected is referred to as an "Output V.A.T." in the hands of the seller and an "Input V.A.T." in the hands of the buyer.

The following diagram best describes Input and Output V.A.T. in the hands of Producer 2:



A key characteristic of a V.A.T. is that the tax burden crystalizes at the level of consumption but is collected at each level of production. Filing and reporting obligations exist at every stage of the production and distribution chain, reflecting the view that the V.A.T. system should be self-policing, which it is to a certain degree.

Remittance of a V.A.T.

The computation of the V.A.T. amount owed to the tax authorities is based on a Taxable Person's Input and Output V.A.T. Thus far, countries have adopted three different methods to calculate the amount of V.A.T. to be remitted: the "Credit Method," the "Subtraction Method," and the "Addition Method."

Credit Method

Under the Credit Method, a Taxable Person deducts its Input V.A.T. from its Output V.A.T. and remits the difference to the tax authorities. This system generally implies compliance with specific invoicing requirements, such as the requirement to separately list V.A.T. on all sales invoices. Since V.A.T. in the E.U. can be imposed at different rates, this method allows a true-up to the proper rate when a product is sold to a Taxable Person in a different country.

Subtraction Method

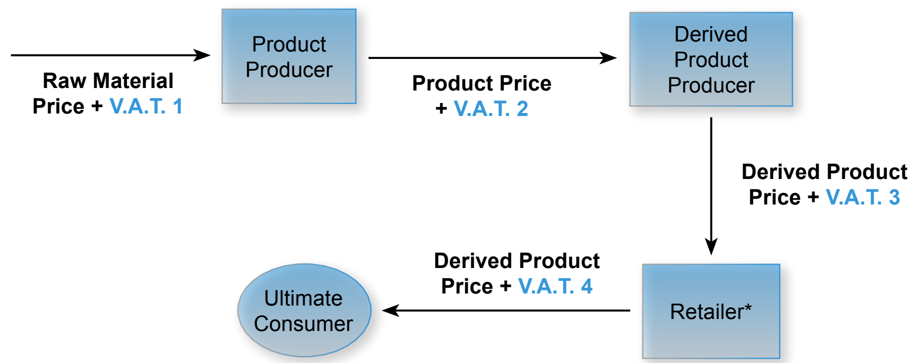
Under the Subtraction Method, a Taxable Person must calculate the value it adds to the good or service it sells. It does so by subtracting the taxed input costs from the sales price of a good or service and then multiplying this difference by the applicable V.A.T. rate. The result must be remitted to the tax authorities. This method differs from the Credit Method in that only local costs are taxed at the Output V.A.T. rate, without affecting the actual rates of Input V.A.T. imposed on the Taxable Person. It accomplishes this by subtracting taxed input costs from sales price generating Output V.A.T.

Addition Method

Under the Addition Method, the taxpayer first calculates its added value by totaling all the untaxed costs of supplying the goods or services (such as wages) and then multiplies this added value by the applicable V.A.T. rate. This amount must be remitted to the tax authorities. This method simply ignores transactions and Input V.A.T. at lower levels in the production chain.

"Under the Credit Method, a Taxable Person deducts its Input V.A.T. from its Output V.A.T. and remits the difference to the tax authorities."

Most countries that are U.S. trade competitors have adopted the Credit Method. As a result, the remainder of this article will focus on this method, which can best be explained by the following diagram:



* sells derived product and raw material for production of product

In this example, every Taxable Person in the production and distribution chain can deduct its Input V.A.T. from its Output V.A.T. and remit the difference to the tax authorities. Thus,

- the product producer remits the difference between V.A.T. 2 and V.A.T. 1,
- the derived product producer remits the difference between V.A.T. 3 and V.A.T. 2, and
- the retailer remits the difference between V.A.T. 4 and V.A.T. 3.

Only the ultimate consumer, who is not a taxable person, will bear the burden of the entire amount of V.A.T. incurred throughout the production and distribution chain.

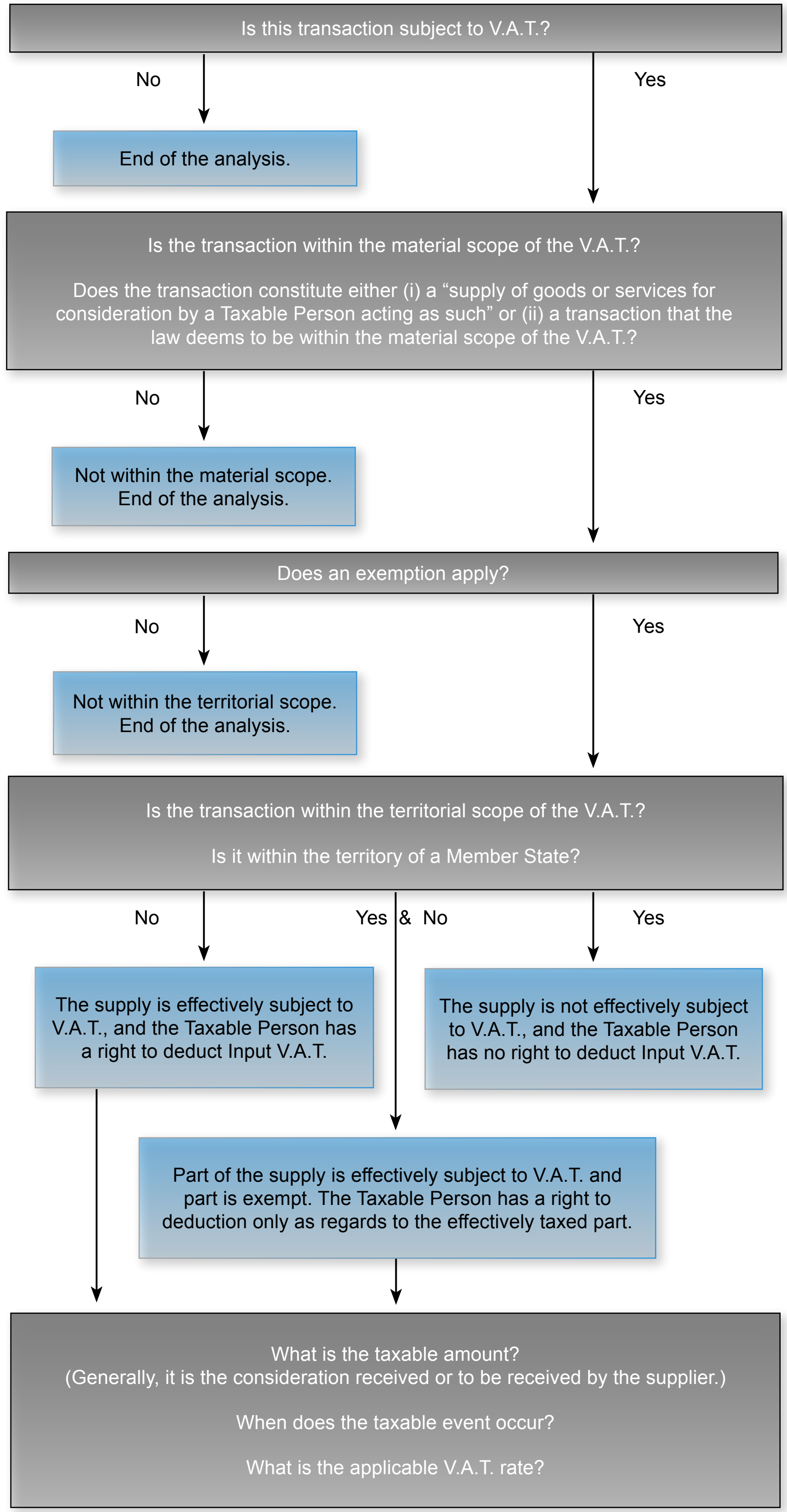
THE EUROPEAN EXAMPLE

Overview

The E.U. was formed to implement a common European market. For this purpose, Member States transferred part of their sovereignty to the E.U. and its institutions. As a result, European institutions can draft legislation that applies to every Member State in certain areas only. Indirect taxes, such as V.A.T., are one such area.

The European V.A.T. system mostly originates from European directives. Once the European Commission issues a directive, every Member State must "transpose" the directive into its own legislation using the means it considers most appropriate to achieve the directive's goal. The V.A.T. directives give every Member State a certain degree of autonomy with regard to specific aspects of internal V.A.T. legislation. As a result, harmonization is not perfect among E.U. Member States – which explains, *inter alia*, the difference in V.A.T. rates among E.U. countries.

In broad terms, the following flow-chart best summarizes a European V.A.T. analysis:



International Aspects

Sale of Goods

For European V.A.T. purposes, three separate categories of cross-border transactions exist in relation to the sale of goods:

- Imports
- Exports
- Intra-community acquisitions

Imports are supplies of goods that are made from outside the European community, from so-called third countries in relation to the E.U. Generally, the acquirer or recipient of the goods must reverse charge ("self-declare") the V.A.T. due on this transaction. In common U.S. sales tax terms, this is a compensating use tax that applies when an item of personal property is acquired from outside the state and brought into the state. An example would be a valuable painting purchased in Paris and imported to the U.S. to hang on the wall of a New York City apartment owned by the purchaser. New York State imposes compensating use tax on the purchaser, as the purchase of the painting was not subject to New York State sales tax.

Exports are supplies of goods from a Member State to a consumer in a third country. With respect to U.S. sales tax, this is equivalent of purchasing a painting from a Beverly Hills gallery that ships the item to the purchaser so that it may be hung on the wall of a New York City apartment. California sales tax will not apply to the transaction.

Intra-community acquisitions are acquisitions of goods from a supplier established in another Member State. Intra-community acquisitions of goods and services are exempt in the Member State of the vendor and usually subject to V.A.T. in the Member State in which the supply ends. As a result, the acquirer must self-declare the V.A.T. due on this transaction. Again, to analogize to a U.S. sales tax fact pattern, this transaction is akin to the purchase of a painting from a gallery in Beverly Hills for delivery to a customer in New York City when the art dealer making the sales operates galleries in New York State and California. For sales tax purposes, the gallery must collect New York State sales tax but not California sales tax.

Sale of Services

The cross-border taxation of services is subject to slightly different rules. In broad terms, when the transaction relates to services and the recipient of the services has a V.A.T. number in another E.U. Member State, the recipient generally must self-declare the V.A.T. due on the services provided. On the other hand, when the services are provided to a person without a V.A.T. number in another E.U. Member State, the supply of services is generally taxable at the supplier's place of business.

To enable the various Member States to track supplies that are exempt from V.A.T. in one Member State but subject to V.A.T. in another, and to ensure that proper V.A.T. is collected, certain obligations are placed on Taxable Persons. These include

- the maintenance of a valid V.A.T. number in all E.U. Member States in which activities for V.A.T. purposes are conducted,

- the designation of a fiscal representative in certain cases to ensure that V.A.T. is collected properly and paid, and
- the filing of a European Declaration of Services or a European Declaration of Goods in which all provisions of intra-community supplies of goods or services are reported.

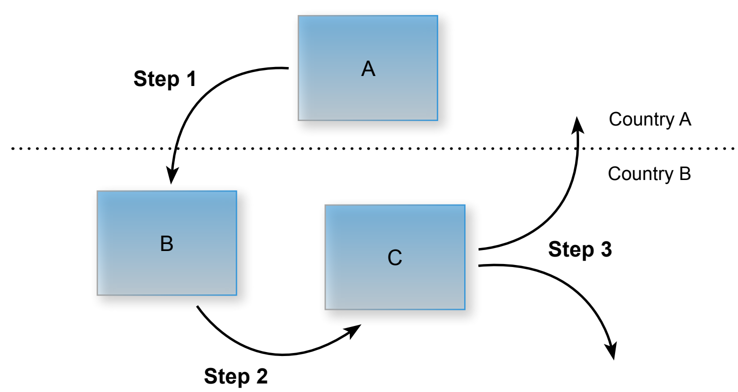
The Potential for "Carousel Fraud"

Carousel fraud in a V.A.T. context generally combines two elements of V.A.T. rules. The first is an intra-community acquisition of goods by a Taxable Person who is registered to collect to V.A.T. The second is the right to deduct Input V.A.T. related to the intra-community transaction.

Generally, this type of fraud occurs in transactions subject to V.A.T. between at least three parties, as in the following example:

- A Taxable Person, A, in Member State A makes a taxable, but exempt, supply to a Taxable Person, B, in Member State B.
- In principle, B must self-declare Input V.A.T. to the tax authorities of Member State B. Nonetheless, B fails to declare and pay input V.A.T. on the intra-community acquisition.
- B resells the good to a related Taxable Person, C, without declaring the sale while charging and collecting V.A.T. on this supply. The collected Output V.A.T. is not declared by B.
- Shortly after the transfer, B is wound up, therefore embezzling V.A.T. proceeds from Member State B (and occasionally harming competition).
- C sells the final goods either in Member State B or in Member State A, collecting V.A.T. and claiming a deduction for the V.A.T. paid to B.

This type of fraud can best be illustrated as follows:



Step 1: Supply exempt for A. B does not pay V.A.T. on the purchase in its country of operation.

Step 2: B resells the goods to C. B collects V.A.T. from C without paying it to Country B. B is wound up.

Step 3: C sells either on Country A market or on Country B market. C claims a deduction/reimbursement of the V.A.T. paid to B. If resold to A, the fraud takes the shape of a carousel.

In reaction to this type of fraud, certain E.U. Member States have adopted legislation that makes every participant that knew or could have known about the fraud in this chain of fraudulent transactions responsible for the payment of the embezzled V.A.T.

CONCLUSION

While V.A.T. certainly raises valuable tax revenues, it also is a tax borne by the final consumer. As such, it has been referred to as an unfair tax on consumers with lower incomes, since lower income taxpayers will incur the same tax burden as higher income taxpayers, thus making the tax proportionately more burdensome for the former. In the U.S., some states have addressed this issue by allowing a refundable credit against state income tax for a fixed amount of purchases based on income levels. Only people with limited incomes are allowed the credit.

Having mastered this basic course in V.A.T. rules imposed by E.U. Member States, the reader is urged to compare these rules with the border adjustment tax when, as, and if finally adopted. The border adjustment tax proposed to date, dramatically differs from a V.A.T. because there is only one point of collection – at the point of entry to the U.S. As with a V.A.T., retailers and others in the distribution chain may attempt to pass the cost to the next person in the chain and on to the ultimate consumer. However, in comparison to a V.A.T., the next person in the chain may refuse to absorb the price increase.

TAX CONCERNS ON OUTBOUND I.P. TRANSFERS: PITFALLS & PLANNING

Author
Philip R. Hirschfeld

Tags
Code §351
Code §361
Code §367(d)
Code §482
Intangible Property ("I.P.")
Outbound Transfer

OVERVIEW

In a 21st century America where new ideas continually create new intangible property ("I.P."), U.S. corporations often desire to contribute their I.P. to a foreign affiliate who then develops and markets the I.P. and its progeny around the world. The desired tax goals are to have the I.P. transferred tax free and defer the U.S. taxation of the profits earned by the foreign affiliate until the profits are repatriated back to the U.S. as a dividend.

When the outbound transfer of I.P. would otherwise receive tax-free treatment under Code §351 (or another tax-free rule), Code §367(d) steps in to prevent tax deferral. Code §367(d) recharacterizes the I.P. transfer as a sale of the I.P. for a future stream of royalties, which are taxable to the U.S. corporate transferor as ordinary income.

In grappling with Code §367(d), careful taxpayer planning is important in many ways. Taxpayer should consider (i) structuring the transfer as a possible taxable sale to avoid Code §367(d); (ii) minimizing the taxable royalty that is imposed under Code §367(d); (iii) separating the I.P. transfer from other steps taken to develop the I.P., such as in a cost sharing arrangement ("C.S.A."); and (iv) grappling with the Code §482 transfer pricing rules that overlay all these actions.

On March 23, 2017, taxpayer planning paid off when the Tax Court delivered the I.R.S. a major defeat in *Amazon.com, Inc. & Subsidiaries v. Commr.*,[1] which dealt with the transfer pricing rules applicable to an outbound I.P. transfer and related C.S.A. This article will explore the rules related to tax-free treatment on outbound transfers of I.P., as well as planning options and the recent *Amazon* case, to reveal the potential tax potholes and the ways that I.P. developers can avoid them or lessen their damage.

BACKGROUND

U.S. pharmaceutical companies, high-tech businesses, and other corporations produce numerous I.P. rights through investment in research and development ("R&D"). This newly developed I.P. is often destined to be held by foreign affiliates engaged in operations around the world.

In such cases, U.S. corporations will generally rely on Code §351 to contribute the I.P. to a foreign corporate affiliate in a tax-free manner. Code §351 will apply if the U.S. corporation owns 80% or more of the foreign affiliate's stock, but the U.S. entity will face additional barriers provided in the Code.

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1 148 T.C. No. 8 (2017).

Barriers to Tax-Free Treatment

One barrier to U.S. tax deferral is the controlled foreign corporation ("C.F.C.") rules. If the foreign affiliate is characterized as a C.F.C.,[2] the income generated by that C.F.C. can be characterized as Subpart F income resulting in immediate taxation to its U.S. shareholders.[3] However, careful structuring of the operations of the C.F.C. can avoid generating Subpart F income.

Royalty income that may be classified as foreign personal holding company income ("F.P.H.C.I."), which generates Subpart F income, can be excluded from F.P.H.C.I. if the C.F.C. derives such income from an active trade or business and receives the royalty from an unrelated person.[4] As a result, the U.S. corporation that created the I.P. may be able to achieve tax deferral by moving the I.P. offshore and accumulating the profits in its foreign affiliate until repatriating those earnings back to the U.S. as a dividend. However, Code §367 is another barrier that must be overcome to achieve that goal.

Section 367(a) Limitations

Code §367(a) creates a general rule, which provides that the Subchapter C non-recognition rules (such as Code §351) do not apply when a U.S. corporation moves assets to a non-U.S. corporation. However, there is a helpful exception to this rule where the transferred assets are used in an active trade or business conducted outside the U.S.[5] This exception can be used to preserve the tax-free transfer of the I.P. if the I.P. is to be used in an active trade or business, which is usually the case.

The active business exception does not apply to certain assets such as inventory and accounts receivable, but these existing limitations do not cover the classic types of I.P. moved offshore.[6] The I.R.S. issued regulations on December 15, 2016, that goodwill and going concern value are not eligible for the active business exception.[7] These regulations provide that a transfer of goodwill or going concern value would be taxable immediately under Code §367(a) or, at the election of the taxpayer, taxable over the useful life of the I.P. under §367(d), as discussed below. Goodwill and going concern value transfers are generally applicable when a business is being moved offshore rather than when select I.P. assets are being transferred. As a result, the I.P. transferor can generally escape the clutches of §367(a), but there is one more Code §367 hurdle: Code §367(d).

Section 367(d) Limitations

Code §367(d) applies to transfers of I.P. from a U.S. corporation to a foreign corporation made under the non-recognition rules of Code §§351 or 361, which applies to corporate reorganizations. This section was created to catch transactions that may escape U.S. taxation until the U.S. taxpayer chooses to repatriate the earnings of its C.F.C. as a dividend or sells or disposes of the C.F.C.

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[2] Code §957.

[3] Code §951(a)(1)(A)(i).

[4] Code §954(c)(1).

[5] Code §367(a)(3).

[6] Code §367(a)(3)(B).

[7] Treas. Reg. §1.367(a)-1(b)(5).

Code §367(d) does not, however, apply in the case of an actual sale or license of I.P. by a U.S. person to a foreign corporation.[8] As a result, a taxpayer may choose to do a taxable sale of the I.P. to a foreign affiliate and then only has to ensure that the sales price is acceptable under the Code §482 transfer pricing rules. A taxable sale should be considered since it may produce less aggregate tax over time and eliminate the annual burdens imposed in complying with Code §367(d).

I.P.[9] subject to Code §367(d) includes any of the following:

- Patents, inventions, formulas, processes, designs, patterns, or know-how
- Copyrights or literary, musical, or artistic compositions
- Trademarks, trade names, or brand names
- Franchises, licenses, or contracts
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data
- Any similar items

The regulations provide that these items are treated as I.P. without regard to whether they are used or developed in the U.S. or in a foreign country, and without regard to whether they are used in manufacturing or marketing activities.[10] While goodwill and going concern value are not in the statutory list of I.P., recently adopted regulations provide that goodwill and going concern value transfers are taxable under Code §367(a), but, at the taxpayer's election, goodwill and going concern value may be treated as I.P. subject to Code §367(d) rather than being immediately taxable under Code §367(a).[11]

Code §367(d) does not impose full, immediate taxation on the transfer of the I.P. Instead, Code §367(d) creates a sale for a series of annual royalty payments "contingent on the productivity, use or disposition of the intangible property," which are deemed paid by the foreign recipient to the U.S. transferor over the "useful life" of the I.P. The final Code §367(d) regulations adopted on December 15, 2016, eliminated the ability to assume a maximum 20-year useful life. The final regulations[12] revised the definition of "useful life" to include "the entire period during which exploitation of

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[8] Treas. Reg. §1.367(d)-1T(g)(4)(i). If I.P. is transferred to a related foreign corporation for no consideration, then no sale or license subject to adjustment under Code §482 shall be deemed to have occurred. Instead, the U.S. transferor is treated as having made a Code §367(d) transfer of I.P. (Treas. Reg. §1.367(d)-1T(g)(4)(i)). However, a royalty-free license may not be subject to this rule and may be able to escape taxation, subject to application of the Code §482 regulations.

[9] Code §367(d)(1), which adopts the definition in Code §936(h)(3)(B). This definition is similar to that set forth in the Code §482 regulations. Excluded from this list are a copyright; a literary, musical, or other artistic composition; a letter or memorandum; or similar property created by the taxpayer (Treas. Reg. §1.367(a)-5T(b)(2); cross-referenced by Treas. Reg. §1.367(d)-1T(b)).

[10] Treas. Reg. §1.367(a)-1T(d)(5)(i), sent. 2; cross-referenced by Treas. Reg. §1.367(d)-1T(b), sent. 1.

[11] Treas. Reg. §1.367(d)-1(c)(3)(ii).

[12] Treas. Reg. §1.367(d)-1(c)(3).

the property is reasonably anticipated to affect the determination of taxable income, as of the time of the transfer."

The regulations include an exception for property with an indefinite useful life or with a life that is reasonably anticipated to exceed 20 years. The exception allows the transferor to take the amount into income during a limited 20-year period. The only catch is that the annual royalty must be increased to take into account the additional value attributable to the period following 20 years (*i.e.*, a transferor still must take into account the present value of all amounts, including amounts after the 20-year period while the property still has useful life).[13] The Code §367(d) regulations then state that the appropriate charge shall be determined in accordance with the provisions of Code §482.[14] As a result, the U.S. transferor recognizes taxable income over the useful life of the I.P. regardless of whether any dividend is received by it from the foreign affiliate.[15]

The cross-reference to the Code §482 rules invokes Treas. Reg. §1.482-4, which addresses methods to determine taxable income in connection with a transfer (or license) of I.P. The bottom line is that the taxpayer will require the assistance of a transfer pricing expert and study to determine the appropriate, arm's length amount for the royalty payment.

Additionally, the determination of the deemed royalty payment may necessitate future adjustments to the deemed royalty payment. The Code §482 regulations provide generally that if I.P. is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it satisfies the "commensurate-with-income" requirement (the "periodic adjustment requirement").[16]

The deemed annual payments under Code §367(d) are characterized as ordinary income of the U.S. transferor, whether or not a sale or exchange of the I.P. would have given rise to capital gain.[17]

Any outbound I.P. transfer is subject to reporting on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*.[18] The U.S. transferor must provide and explain the calculation of the deemed payment.[19]

I.P.'S ROLE IN COST SHARING ARRANGEMENTS

I.P. is at the core of C.S.A.'s, which are often undertaken in high-tech, pharmaceutical, and other industries.

A C.S.A. is an arrangement between two parties under which the parties agree to share the costs of developing I.P. in proportion to each party's share of reasonable

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13 Treas. Reg. §1.367(d)-1(c)(3)(ii).

14 Treas. Regs. §§1.367(a)-1(b)(3), (c).

15 Code §367(d)(2)(A)(ii)(I).

16 Treas. Reg. §1.482-4(f)(2)(i).

17 Code §367(d)(2)(C); Treas. Reg. §1.367(d)-1T(c)(1).

18 Treas. Reg. §1.6038B-1(b)(1).

19 Treas. Reg. §1.6038B-1T(d)(1)(v).

anticipated benefits ("R.A.B.") from the I.P.[20] In a C.S.A., buy-in payments – which are referred to as platform contribution transaction ("P.C.T.") payments – are often required to be paid for the transfer of any resource, capability, or right that is reasonably expected to contribute to the development of the I.P.

C.S.A.'s are often undertaken between a U.S. corporation and an affiliated foreign company. This results in income recognition by the U.S. corporation when a P.C.T. payment is received from a foreign affiliate, as well as the application of the Code §482 transfer pricing rules. For transfer pricing purposes, the parties will likely desire to lower the amount of income recognized by the U.S. corporation by selecting an appropriate transfer pricing method for the P.C.T. payment. To achieve this tax goal, the foreign affiliate will pay for the I.P. based on the cost of development, rather than on the value of the development after the I.P. has been created. However, the I.R.S. may disagree with that approach, so as to increase the amount of income recognized by the U.S. corporation.

"The Tax Court determined that the I.R.S.'s valuation method with respect to the buy-in payment was 'arbitrary, capricious, and unreasonable.'"

In the 2009 Tax Court case *Veritas Software Corp. v. Commr.*,[21] a U.S. parent company granted its Irish subsidiary the right to use all its existing technical and marketing intangibles to develop software under a C.S.A. In consideration for such transfer, the Irish subsidiary made a P.C.T. payment to the U.S. parent calculated under the comparable uncontrolled transaction ("C.U.T.") method. Under this method, the payment is based on the amount a third party would have paid the U.S. parent for the intangibles in a comparable transaction.

The I.R.S. did not agree with the taxpayer and asserted that the C.U.T. method was not the right method to use under Code §482. Rather, the I.R.S. asserted that the income method should have been used on an aggregate basis with all related transactions. This method would have determined the appropriate P.C.T. payment based on the future expected income stream from the developed I.P. The I.R.S. position would have led to more than ten times the income actually reported by the U.S. parent. However, the Tax Court held for the taxpayer.

In the absence of specific regulations addressing C.S.A.'s, the Tax Court sustained the use of the C.U.T. method and rejected the I.R.S.'s use of aggregation and the income method. The I.R.S. did not appeal *Veritas* but did issue an Action on Decision stating that it disagreed with the Tax Court.[22]

In 2009, the I.R.S. published proposed and temporary Code §482 regulations, which were adopted two years later in final form.[23] These regulations contain rules for how to value P.C.T. payments and include the income method that the I.R.S. unsuccessfully tried to apply in *Veritas*. These regulations also state that an aggregation approach to valuing transfers involved in a C.S.A. "may" be appropriate to determine the combined effect of multiple contemporaneous transactions that include the C.S.A. and other related I.P. transfers.[24]

On March 23, 2017, the Tax Court reaffirmed its thinking in the *Veritas* transfer

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20 Robert Weissler *et al.*, "APA Training: Cost Sharing" (presentation, October 15, 2001).

21 133 T.C. 297 (2009).

22 A.O.D. 2010-05, I.R.B. 2010-49 (December 6, 2010).

23 Treas. Reg. §1.482-7.

24 Treas. Reg. §1.482-7(g)(2)(iv).

pricing case in *Amazon.com, Inc. & Subsidiaries v. Commr*.[25] In the latter case, Amazon.com, Inc. and its domestic subsidiaries (collectively "Amazon") entered into a C.S.A. with a Luxembourg subsidiary and gave the subsidiary the right to use some of its I.P. The subsidiary agreed to make an up-front payment as well as annual payments to Amazon to compensate for the use of the I.P. The I.R.S. disagreed with Amazon's pricing methodology and instead called for the use of a method that, Amazon asserted, was the same one rejected by the Tax Court in the *Veritas* decision. Once again, the Tax Court rejected the I.R.S. claim and held for the taxpayer.

The Tax Court determined that the I.R.S.'s valuation method with respect to the buy-in payment was "arbitrary, capricious, and unreasonable." The court held that Amazon's use of the C.U.T. method, with adjustments, was the best method to determine the buy-in payment. The court also accepted Amazon's use of the cost allocation method, whereby parties that have entered into a C.S.A. share "all of the costs incurred . . . related to the intangible development,"[26] to determine later year payments.

The decision shows that the taxpayer's choice of transfer pricing method is important to reduce tax. In *Amazon*, the taxpayer chose an allocation method essentially similar to that used in the *Veritas* decision and, like the taxpayer in that earlier case, achieved a major victory. While the I.R.S. may try to require use of a method that produces a higher tax bill, the Tax Court has been supportive of the taxpayer's choice of method.

OVERLAP BETWEEN CODE §§367 AND 482

One multi-transaction scenario that concerns the I.R.S. occurs when (i) I.P. is transferred to a foreign subsidiary in a Code §351 tax-free contribution, which triggers application of Code §367(d), and then (ii) a C.S.A. is entered into between the U.S. parent and its foreign subsidiary for which P.C.T. payments are made, which triggers application of Code §482.

On September 14, 2015, the I.R.S. published temporary regulations under Code §§482 and 367(d), which specifically indicated that the I.R.S. could consolidate two such related transactions for the purposes of Code §§367(d) and 482:

> The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of § 1.482-1(c).[27]

The temporary regulations included an example in which the U.S. parent wanted to separate two transactions so as to reduce its aggregate tax exposure. In the first transaction, P, a U.S. corporation, contributes the foreign rights to conduct its business, including the foreign rights to its I.P., to a newly-incorporated, wholly-owned

[25] 148 T.C. No. 8 (2017).

[26] Treas. Reg. §1.482-7(d)(1).

[27] Treas. Reg. §1.482-1T(f)(2)(i)(E).

foreign subsidiary, S1. In the second transaction:

> P and S1 enter into a cost sharing arrangement ("CSA") to develop and exploit the rights to conduct the Business. Under the CSA, P is entitled to the U.S. rights to conduct the Business, and S1 is entitled to the rest-of-the-world ("ROW") rights to conduct the Business. P continues after Date Y to perform the Support, employing resources, capabilities, and rights that as a factual matter were not contributed to S1 in the Date X transaction, for the benefit of the Business world-wide. Pursuant to the CSA, P and S1 share the costs of P's Support in proportion to their reasonably anticipated benefit shares from their respective rights to the Business.[28]

"While the ruling may not diminish the I.R.S.'s desire to maximize an I.P. transferor's income, careful planning on the part of the taxpayer could deter I.R.S. challenges."

In the example, the taxpayer took the position that these were two separate transactions:

> P treats the Date X transaction as a transfer described in section 351 that is subject to 367 and treats the Date Y transaction as the commencement of a CSA subject to section 482 and § 1. 482-7. P takes the position that the only platform contribution transactions ("PCTs") in connection with the Date Y CSA consist of P's contribution of the U.S. Business IP rights and S1's contribution of the ROW Business IP rights of which S1 had become the owner on account of the prior Date X transaction.[29]

The I.R.S. disagreed with the taxpayer and maintained that the two transactions could be collapsed together if doing so would produce greater income recognition for the U.S. parent than if the two transactions were treated separately.

CONCLUSION

I.P. transfers to offshore entities are often made by U.S. multinational corporate groups. The I.R.S. has focused on these transactions under two separate anti-deferral regimes: Code §§367(d) and 482. While these rules are difficult enough to deal with on their own, more complexity was added when the I.R.S. adopted regulations that will allow them to apply these rules on an aggregate basis if that may produce greater income recognition. However, the Tax Court's recent *Amazon* decision shows that the court has been deferential to taxpayers who prepare and document a comprehensive transfer pricing analysis. While the ruling may not diminish the I.R.S.'s desire to maximize an I.P. transferor's income, careful planning on the part of the taxpayer could deter I.R.S. challenges. If not, the road ahead may have more potholes for the I.R.S. than the taxpayer.

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28 *Id.*, ex. 6.

29 *Id.*

VALUATION – MORE ART THAN SCIENCE

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Tags
Artwork
Code §2031
Estate and Gift Tax

INTRODUCTION

A recent Tax Court Memorandum decision,[1] involves the valuation of two Old Masters paintings for estate tax purposes. An expert at a famous auction house was retained by the estate. His reasoned opinion as to the value was dismissed by the court when one of the works was actually sold by the estate several years later for more than four times the amount determined in the expert valuation report. While subsequent events generally are not considered in determining valuation at a specific date, they can be relevant and were indeed relevant here. In sum, the case provides an example of what not to do when a decedent owns valuable art.

FACTS

In *Kollsman*, the decedent was a U.S. citizen who owned two 17th-century paintings at the conclusion of life. The paintings needed to be valued for estate tax purposes, and Sotheby's was retained to perform the valuation. Sotheby's also held exclusive rights to sell the paintings for the estate. The fee for the valuation was subsumed in the general fees that Sotheby's would receive as a result of the sale. The valuation report was prepared by the co-chair of Sotheby's Old Master Paintings Worldwide. He stated that the values of the paintings were impaired as they were in such an unclean condition that cleaning might cause irreparable harm. Accordingly, the paintings were valued at $500,000 and $100,000, and this was the valuation that the estate recorded on the decedent's estate tax return. Several months later, the paintings were cleaned and one painting was sold 34 months later for a hammer price of $2,100,000 and a total price $2,434,500, taking account a buyer's premium fee to Sotheby. The I.R.S. asserted that the actual value of the paintings was $2,100,000 and $500,000, and adjusted the decedent's U.S. estate tax liability accordingly.

IN GENERAL

U.S. citizens and non-citizen individuals that are domiciled in the U.S. ("U.S. individuals") are subject to the U.S. estate tax on global assets held at the conclusion of their lifetimes.[2] U.S. tax law allows a credit that is the equivalent of a lifetime gift tax and estate tax exemption U.S. individuals. The nominal amount of the exclusion is U.S. $5,000,000,[3] which is indexed for inflation beginning in 2011.[4] For 2017, the

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1 *Estate of Eva F. Kollsman, et al. v. Commr.*, T.C. Memo 2017-40.

2 Code §2033.

3 Code §2010(c)(3)(A).

4 Code §2010(c)(3)(B).

exemption amount is U.S. $5.49 million.[5]

The U.S. estate tax base (the "gross estate") of a U.S. citizen includes all property, no matter where located.[6] This includes tangible property, personal property, and real property, including artwork. The gross estate tax value is reduced by deductions.[7] The value of a property is determined based on "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[8]

The estate bears the burden of proving the values that the I.R.S. determines in a statutory deficiency notice are incorrect.[9] The I.R.S. bears the burden to prove the values it asserts in a deficiency notice.[10]

COURT HOLDING

The Tax Court noted that a valuation expert is obligated to present his or her case in an objective fashion, with detached neutrality and without bias.[11] Further, experts lose credibility if they become advocates for a party's position.[12] The Sotheby's expert indicated that his valuation was based on the grimy nature of the paintings and that the difference in his date of death valuation and the sales price valuation was due to a combination of the paintings being cleaned and an increased interest from Russian buyers.

Since the paintings were later cleaned by another party without incurring damage, the court believed that the expert exaggerated the delicate nature of the paintings to reduce their valuation for U.S. estate tax purposes. Instead, the court discounted the expert's valuation for the following reasons:

- A willing buyer and seller would investigate and find that the paintings could be cleaned without incurring damage.
- The expert did not provide a valuation list of comparable paintings, so the court could not compare whether the estimated value provided by the expert was appropriate.
- The expert was possibly incentivized to provide a low valuation to obtain the auctioneering business from the sale of the paintings. The expert's firm had a financial interest in obtaining the paintings for auction.

To some extent, the court disagreed with the I.R.S. valuation expert and held that the unclean nature of one of the paintings justified a 5% discount from the value

5 Rev. Proc. 2016-55.

6 Code §2031(a).

7 Code §2053(a). This includes the lifetime exemption, funeral and administrative expenses, indebtedness, and claims against the estate.

8 Treas. Regs. §20.2031-1(b).

9 *Welch v. Helvering*, 290 U.S. 111, 1933.

10 Code §142(a).

11 *Kollsman*, at 16.

12 *Id.*

determined by the I.R.S. The court allowed a further discount for the second painting, as the estate's expert and the I.R.S. expert disagreed as to the actual identity of the painter of the painting.

CONCLUSION

There are several takeaways from the *Kollsman* case. Practitioners should note that post-valuation events may cause a court to change a date of death valuation. Accordingly, a plan that relies on a low valuation to reduce U.S. estate tax liability may not be feasible if later results demonstrate that the actual value is much higher than the valuation price. For the valuation to be valid, estate planners should only employ valuators who do not have an interest in the items they are evaluating. Finally, valuators must have data to defend their decision making. This evidence should include comparable values of similar items. In sum, the pedigree of the evaluator is less important than the preparation of a credible and complete report.

"A plan that relies on a low valuation to reduce U.S. estate tax liability may not be feasible if later results demonstrate that the actual value is much higher."

HOW TO CALCULATE GAIN OR LOSS ON PAYABLES & RECEIVABLES DENOMINATED IN NONFUNCTIONAL CURRENCY

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Tags
Currency Gain or Loss
Foreign Currency
Section 988 Transactions

INTRODUCTION

If all currencies were pegged to one single standard and did not fluctuate in value among themselves, the concept of currency gain and loss would not be needed. To illustrate, if two foreign currency units ("F.C.U.") were to equal one U.S. dollar ("U.S.D."), each time an invoice for F.C.U. 50 would be received and ultimately paid, a U.S. taxpayer would know that the amount set forth in the invoice and the amount of the payment would equal U.S.D. 25. However, major currencies tend to fluctuate. An invoice received for F.C.U. 50 may be worth U.S.D. 25 at the time the invoice is received but worth only U.S.D. 23 at the time the invoice is paid. In this set of circumstances, a uniform method must be applied to identify the amount of the transaction when the books and records of the business are stated in U.S.D. In our example, a U.S. business satisfying an invoice denominated in the amount of F.C.U. 50 could be booked at (i) U.S.D. 25, the value of the foreign currency on the date of receipt, or (ii) at U.S.D. 23, the date of the payment, or (iii) at U.S.D. 25 as a payable satisfied with U.S.D. 23 and U.S.D. 2 as some income or gain.

In an International Practice Unit,[1] the Large Business and International ("LB&I") Division of the I.R.S. provided a broad overview of how currency gains and losses are recognized for U.S. tax purposes. In simple terms, currency gains and losses reflect the movement in value of a transaction between the booking date and the payment date when the transaction is denominated in a foreign currency in relation to the taxpayer.

BASIC CONCEPTS

Transactions generally are accounted for in a taxpayer's functional currency. The functional currency of a U.S. taxpayer, such as a U.S. corporation, generally is U.S.D.

Regardless of its functional currency, a taxpayer's U.S. tax liability must be determined and paid in U.S.D. Thus, when U.S. taxpayers engage in business or investment transactions denominated in foreign currency, foreign currency amounts must be translated into U.S.D. As discussed in detail below, such transactions may give rise to functional currency gain or loss.

A qualified business unit ("Q.B.U.") is a separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. Every corporation, whether domestic or foreign, is a Q.B.U. Further, an activity of a corporation may be a Q.B.U. if it is a trade or business and a separate set of books

1 Document Control Number ("D.C.N.") FCU/CU/C-18.2.1_04(2016), *Character of Exchange Gain or Loss on Currency Transactions*, as of June 1, 2016.

and records are maintained. For example, the London office of a U.S. corporation may be a Q.B.U. if its activities constitute a trade or business and if separate books are kept for the office.

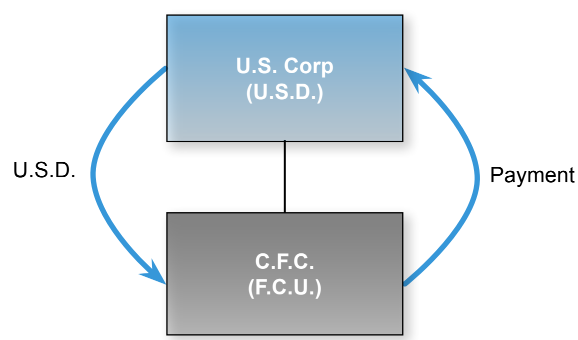
A Q.B.U., as a separate and clearly identified unit of a U.S. taxpayer, may have a functional currency other than U.S.D. if (i) the economic environment in which a significant part of the Q.B.U.'s activities are conducted is not U.S.D. and (ii) the Q.B.U. does not keep its books and records in U.S.D. For example, a foreign branch of a U.S. corporation may have a functional currency that is not U.S.D.

SECTION 988 TRANSACTIONS

Since transactions generally are accounted for in the taxpayer's or Q.B.U.'s functional currency, certain nonfunctional currency transactions, called "Section 988 Transactions" give rise to functional currency gain or loss. Internal Revenue Code ("Code") §988 applies to several types of transactions involving a taxpayer's nonfunctional currency.

Among the Section 988 Transactions are those described as "accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account."[2] Thus, for example, an account payable or account receivable that is held by a taxpayer and denominated in nonfunctional currency is subject to Code §988. Also, treated as Section 988 Transactions are the acquisition of a debt instrument (or becoming the obligor of a debt instrument); the acquisition of any forward contract, futures contract, option, or similar financial instrument; and the disposition of nonfunctional currency.

The following diagram illustrates that, in a simple cross-border loan, one party or the other will incur a currency loss or gain in connection with movements in the value of the currency in which the principal is denominated. In the example, the C.F.C. is exposed to currency risk, as the amount owed to its parent, U.S. Corp, will rise and fall with the relative fluctuations in currency.



Note that for financial accounting purposes the gain or loss is realized on an immediate basis.[3] For tax purposes, the gain or loss is deferred until a payment of principal is made.

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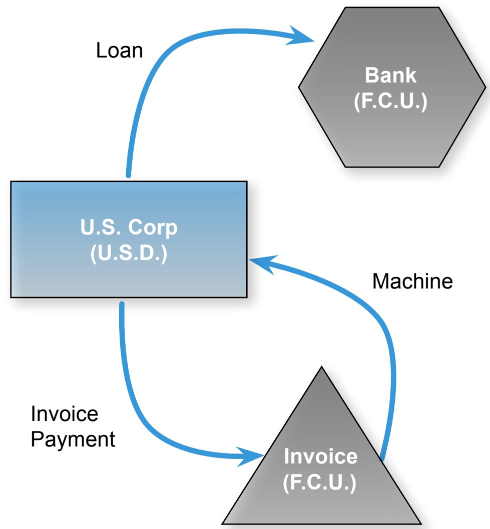
[2] Code §988(c)(1)(B)(ii).

[3] ASC 830-20-35, formerly FAS 52.

The following diagram illustrates that not all movements in the value of a currency result in a foreign currency gain or loss. In the example, U.S. Corp is an accrual basis taxpayer with U.S.D. as its functional currency. It borrows F.C.U. 100 from a bank in 2017. Interest accrues quarterly on the loan. The loan from bank is a five-year note with a face amount of F.C.U. 100.

U.S. Corp separately orders a machine for F.C.U 100. The invoice for the machine is payable at 60 days upon delivery. The value of F.C.U. 100 at the time of delivery is U.S.D. 110. At the time the invoice is paid, the value of F.C.U. 110 is U.S.D 105.



In the foregoing scenario, the tax results of the loan and the purchase are as follows:

- The purchase of the machine is not a Section 988 Transaction. U.S. Corp records an asset for $110 and an account payable of $110 when the machine is received.
- The payment of the F.C.U. account payable is a Section 988 Transaction and gives rise to foreign currency gain or loss. Here, there is ordinary gain of $5. The gain is U.S.-source gain under the residence rule of sourcing.
- The five-year note denominated in terms of F.C.U. gives rise to currency gain or loss at the time of payment of principal. To the extent that accrued interest is paid with currency that has appreciated or depreciated in value between the booked date and the payment date, the gain or loss will be recognized.

THE CALCULATION

As discussed above, a U.S. taxpayer or Q.B.U. must compute its foreign currency gains or losses on its Section 988 Transactions,[4] which include transactions involving the accrual of an expense (such as an account payable) or income (such as an account receivable) that is paid or received after the accrual date and denominated

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[4] The rules of Code §988 may apply to foreign taxpayers, however only in the relatively unusual case of a foreign taxpayer with a U.S. investment or business transaction denominated in a foreign currency.

in a currency other than the taxpayer's or the Q.B.U.'s functional currency.

The exchange gain or loss on an account payable or an account receivable is recognized on the date that the payment of nonfunctional currency is made or received.

The exchange gain or loss on an item of gross income or receipt recorded as an account receivable that is denominated in a nonfunctional currency is computed as follows:

1. Determine the nonfunctional currency accrued as an account receivable.
2. Multiply that amount by the spot rate at the booking date.
3. Determine the nonfunctional currency received as payment on the account receivable.
4. Multiply that amount by the spot rate on the payment date.
5. Subtract 2 from 4.

"The regulations allow a taxpayer or Q.B.U. to utilize a spot rate convention . . . when computing exchange gains or losses on nonfunctional currency accounts receivable and payable."

The exchange gain or loss on an item of expense recorded as account payable that is denominated in a nonfunctional currency is computed in a similar fashion:

1. Determine the nonfunctional currency paid on the account payable.
2. Multiply that amount by the spot rate at the booking date.
3. Determine the nonfunctional currency accrued as an account payable.
4. Multiply that amount by the spot rate on the payment date.
5. Subtract 2 from 4.

Further, the regulations allow a taxpayer or Q.B.U. to utilize a spot rate convention, to be determined at intervals of one quarter year or less, when computing exchange gains or losses on nonfunctional currency accounts receivable and payable. Alternatively, the taxpayer or Q.B.U. may use the spot rate at the actual booking or payment dates. The recognition date is the date on which the payment is made or received.

The following examples illustrate the calculation of exchange gain on an account payable and exchange loss on an account receivable. In each example, U.S. Corp is a calendar year corporation with U.S.D. as its functional currency. The last example illustrates the spot rate convention option on a monthly basis.

Example 1: Exchange Gain or Loss on Satisfaction of an Account Payable in Nonfunctional Currency

On January 15, 2017, U.S. Corp purchases inventory on account from a wholly-owned foreign subsidiary, C.F.C. 1, for F.C.U. 10,000. The spot rate on that day is F.C.U. 1 = U.S.D. 0.55.

On February 23, 2017, when U.S. Corp makes payment of the F.C.U. 10,000 account payable, the spot rate is F.C.U. 1 = U.S.D. 0.50. Accordingly, U.S. Corp will realize an exchange gain on the F.C.U. 10,000 account payable.

U.S. Corp's gain is computed by first multiplying F.C.U. 10,000 by the spot rate on the booking date:

- F.C.U. 10,000 x U.S.D. 0.55 = U.S.D. 5500

Then, F.C. 10,000 is multiplied by the spot rate on the payment date:

- F.C.U. 10,000 x U.S.D. 0.50 = U.S.D. 5000

Finally, the translated amount booked is subtracted from the translated amount paid:

- U.S.D. 5500 – U.S.D. 5000 = U.S.D. 500

Accordingly, U.S. Corp's exchange gain on the transaction is U.S.D. 500. The character of the exchange gain is ordinary.

Also, note that there could be an exchange gain or loss on the disposition of F.C.U. by U.S. Corp, depending on when U.S. Corp acquired the F.C.U.

Example 2: Exchange Gain or Loss on Receipt of an Account Receivable in Nonfunctional Currency

On January 15, 2017, U.S. Corp sells inventory to a wholly-owned foreign subsidiary, C.F.C. 2, for F.C. 10,000. The spot rate on that day is F.C.U. 1 = U.S.D. 0.55.

On February 23, 2017, when U.S. Corp receives the payment of the F.C.U. 10,000 account receivable from C.F.C. 2, the spot rate is F.C.U.1 = U.S.D. 0.50. Accordingly, on that date, U.S. Corp will realize an exchange loss on the F.C.U. 10,000 account receivable.

U.S. Corp's loss is computed by first multiplying F.C.U. 10,000 by the spot rate on the date the F.C.U. 10,000 are received.

- F.C.U. 10,000 x U.S.D. 0.50 = U.S.D. 5000

Then, F.C.U. 10,000 is multiplied by the spot rate on the booking date:

- F.C.U. 10,000 x U.S.D. 0.55 = U.S.D. 5500

Finally, the translated amount booked is subtracted from the translated amount received:

- U.S.D. 5000 – U.S.D. 5500 = U.S.D. (500)

Accordingly, U.S. Corp's exchange loss on the transaction is U.S.D. 500. The character of the exchange loss is ordinary.

Again, note that there could be an exchange gain or loss on the disposition of F.C.U. by U.S. Corp, depending on when U.S. Corp acquired the F.C.U.

Example 3: Spot Rate Convention Option

U.S. Corp uses a spot rate convention to determine the spot rate as provided under the regulations.

The spot rate determined under the spot rate convention for the month of January is F.C.U. 1.00 = U.S.D. 0.54 and for the month of February is F.C.U. 1.00 = U.S.D. 0.51.

On January 15, 2017, U.S. Corp sells inventory for F.C.U. 10,000. On February 23, 2017, U.S. Corp receives payment for the inventory of F.C. U. 10,000.

As a result, on the last date in February, U.S. Corp will realize exchange loss. The exchange loss is computed by first multiplying the F.C.U. 10,000 by the spot rate convention for the month of February:

- F.C.U. 10,000 x U.S.D. 0.51 = U.S.D. 5100

Then, F.C. 10,000 is multiplied by the spot rate convention for the month of January:

- F.C.U. 10,000 x U.S.D. 0.54 = U.S.D. 5400

Finally, the spot rate translated amount received in February is subtracted from the spot rate translated amount accrued in January:

- U.S.D. 5,100 – U.S.D. 5400 = U.S.D. (300)

Accordingly, U.S. Corp has an exchange loss in the amount of U.S.D. 300.

CONCLUSION

Because the value of currency fluctuates, a cross-border financial transaction that is booked in a nonfunctional currency will likely give rise to currency gain or loss when the transactional value (measured in terms of a functional currency) varies between the date of booking and the date of payment.

CODE §163(J) – IGNORING U.S. THIN CAPITALIZATION RULES MAY LEAVE TAX ADVISORS THINLY PREPARED FOR AUDITS

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Tags
Code §163(j)
Interest Deduction
Thin Capitalization

INTRODUCTION

Using deductible interest payments to reduce U.S. taxable income is often a goal of tax practitioners. These payments are often disbursed to foreign related parties, where the interest income is subject to little or no tax. The U.S. has developed rules that limit the deductibility of these interest payments when the payor is a thinly capitalized corporation and the creditor is a related party that is subject to a reduced tax rate in its country of residence as compared to the U.S. rate. Deductibility is also limited when a person related to the lender makes a "disqualified guarantee" of the debt to an unrelated creditor and no gross basis tax is imposed on the interest.

Example 1: Apple Pie Corporation ("Apple Pie") is incorporated in Florida. It is wholly owned by Papaya Inc. ("Papaya"), a corporation incorporated in a jurisdiction that has a tax treaty with the U.S. and a 0% corporate tax rate. Apple Pie was incorporated with $100 of debt from Papaya and has no other assets. Each month, Apple Pie pays interest to Papaya based on its debt agreement. Apple Pie deducts this interest payment in the U.S., thus lowering its U.S. tax liability.

Absent any regulation or Code section, the interest deduction taken by Apple Pie would reduce any U.S. taxable income. Conversely, the interest payment would not be subject to tax in Papaya's country of residence.

CODE §163(J)

Earnings stripping rules are intended to prevent the erosion of the U.S. tax base of a thinly capitalized corporation by means of excessive deductions for certain interest expense. Proposed regulations were issued in June 1991 (the "Proposed Regulations"). However, the Proposed Regulations have not yet been finalized. To remedy the problem, Congress created Code §163(j).

The earnings stripping provisions under Code §163(j) limit the deductibility of interest payments made to related tax-exempt entities (including related foreign persons). The rules apply to both U.S. companies and foreign companies engaged in a U.S. trade or business[1] if the following conditions are met:

1. The company pays or accrues "exempt related-party interest."

2. It has <u>both</u>

    a. a debt-to-equity ratio exceeding 1.5:1[2] at the close of the tax year and

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[1] Prop. Treas. Reg. §1.163(j)-1(a)(1)(ii).

[2] Code §163(j)(2)(A)(ii).

b. excess interest expense.[3]

If a company meets all these criteria, it must determine the interest deduction disallowed under Code §163(j).

Disallowed interest expense is carried over to future years and treated as interest paid or accrued in the succeeding taxable year. Thus, falling under the earnings stripping rules does not result in a denial, but rather a deferral, of deductible corporate interest expense.

If either of the criteria under condition 2 is absent (*i.e.*, debt-to-equity ratio not exceeding the 1.5:1 threshold or no excess interest expense), there is no earnings stripping limitation on a corporation's ability to deduct related-party interest expense. There are, however, proposed anti-avoidance rules, which provide that arrangements will be disregarded if they have been entered into with a principal purpose of avoiding the earnings stripping rules.[4]

Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*, is used by taxpayers to report disallowed interest amounts under the earnings stripping rules. The form was issued by the I.R.S. in December of 2008. The form strictly follows the statute, which differs, in some cases, from the Proposed Regulations. The Proposed Regulations deviate from the Code in setting forth additional adjustments to, *inter alia*, the adjusted taxable income.

APPLICABILE SCENARIOS

As mentioned in the introduction, there are two distinct scenarios where Code §163(j) will apply: (i) where the payment is made to a related party and (ii) where the payment is made to unrelated party who makes a "disqualified guarantee" to the payor.

Related Person

With regard to the former scenario, a person is "related" if it satisfies any of the definitions within Code §267(b) or Code §707(b)(1).[5] Under Code §267, two members of the same controlled group are considered to be related.[6]

Two corporations are members of a controlled group where

- one entity owns more than 50% of the total voting power of all voting classes or more than 50% of the total value of all shares of each of the corporations, except the common parent corporation is owned by one or more of the other corporations; and
- the common parent corporation owns more than 50% of the total voting power of all the voting classes or more than 50% of the total value of shares of

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3 Code §163(j)(2)(A)(i).

4 Prop. Treas. Reg. §§1.1.63(j)-1(f), 1.163(j)-3(c)(5), 1.163(j)-6(b)(3). The Proposed Regulations are not consistent in this regard.

5 Code §163(j)(4).

6 Code §267(b)(3),

all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations. [7]

All members of an "Affiliated Group" are treated as one corporation, whether or not the members file a consolidated return.[8]

Disqualified Guarantee

The second scenario involves a fact pattern where a guarantee is given by a related exempt person or a related foreign person and the interest income is not subject to the standard U.S. withholding tax.[9] The definition of "guarantee" can be very broad and includes any arrangement where a person, either directly or indirectly through an entity or otherwise, assures the payment of another person's obligation. The guarantee can be either direct or indirect and include a financial contribution to keep the debtor solvent.

The results of the disqualified guarantee are the same as when a payment is made to a related party.

DETERMINING THE DEBT-TO-EQUITY RATIO

For the interest expense limitation to apply, the debt-to-equity ratio must exceed 1.5. This determination is made on the last day of the taxable year. The ratio would be determined as follows:

$$\text{Debt-to-Equity Ratio} = \frac{\text{Cash + Other Assets}}{\text{(Cash + Other Assets) – Debt}}$$

Example 2: In Year 1, Apple Pie has a loan with its parent, Papaya Inc. ("Papaya"), valued at $600 and wishes to deduct its interest payment to Papaya. Apple Pie also has real property with a fair market value of $300 and $600 cash from the loan. The numerator is $600 and the denominator is $300 (*i.e.*, $300 + $600 - $600). Therefore, the debt-to-equity ratio is 2. Should Apple Pie satisfy the other elements present in Code §163(j), some of its interest deduction may be denied and carried over to the following year.

Example 3: The conditions are the same as in Example 2, but this time, the debt is valued at $300 and the real property is valued at $200. The debt-to-equity ratio is 1.5. The interest deduction is not disallowed under Code §163(j) since the debt-to-equity ratio does not exceed 1.5.

Example 4: The conditions are the same as in Example 3 above, but this time, Papaya guarantees a loan made from an unrelated foreign bank to Apple Pie. This

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7 Code §267(f), referencing Code §1563(a)(1) with substitutions.

8 Code §1504(a).

9 Code §163(j)(6)(D)(ii)(I). A controlling interest is direct or indirect ownership of at least 80% of the total voting power and value of all classes of stock of a corporation, or 80% of the profit and capital interests in any other entity. A related person does not include an entity that is 80% controlled by the payor.

is a “disqualified guarantee” since Papaya and Apple Pie are related, but because the debt-to-equity ratio does not exceed 1.5, any interest deduction by Apple Pie is not disallowed under Code §163(j).

DETERMINING NET INTEREST EXPENSE

Net interest expense is the excess of the amount of interest expense paid or accrued over the interest income.[10] It can be represented in the following formula:

Net Interest Expense = Interest Expense Paid/Accrued – Interest Income

Example 5: Apple Pie earns $100 of interest income from its bank account. However, it also has an outstanding loan with another bank and pays $30 of interest on the loan. Its net interest expense is $70 (*i.e.*, $100 of interest income - $30 of interest paid).

DETERMINING ADJUSTED TAXABLE INCOME

Adjusted Taxable Income (“A.T.I.”) is computed as follows:

A.T.I. = Taxable Income + Net Interest Expense[11] + Net Operating Loss Deduction[12] + Deductions for Depreciation, Amortization, or Depletion + Domestic Production Deduction + Other Adjustments

Since a disallowance only occurs if the net interest expense exceeds 50% of A.T.I., it benefits the taxpayer if the A.T.I. is high, as it will result in a smaller disallowance.

DETERMINING EXCESS INTEREST EXPENSE

As mentioned above, a deduction will be limited to the “excess interest expense” for the tax year. Excess interest expense is the net interest expense over 50% of its adjusted taxable income, plus any “excess limitation” carryforward.[13]

An excess limitation carryforward from up to three preceding years can be used as an adjustment to A.T.I. for any current tax year.

Example 6: During Year 1, Apple Pie has $200 of A.T.I., including $40 of interest income and 90$ of interest expense, $60 of which is paid or accrued to Papaya and $30 is paid or accrued to unrelated persons. Apple Pie has no excess limitation carryforward and its debt-equity ratio exceeds 1.5. to 1.

Apple Pie’s interest expense for Year 1 is $50, the difference between its net interest expense of $50 (*i.e.*, $90 interest expense - $40 interest income) and $100 (*i.e.*,

10 Code §163(j)(6)(B).

11 Code §172

12 Code §199

13 Code §163(j)(2)(B)(i)-(ii), (j)(6)(B).

> ***"Practitioners should also be aware that LB&I has released a step-by-step plan to assist auditors when analyzing interest payments that may implicate Code §163(j)."***

50% of Apple Pie's $200 of A.T.I.). The payment to Papaya is $60 and is greater than its $50 excess interest expense by $10. Therefore. $10 of the interest deduction is disallowed and carry forwarded to Year 2.

CONCLUSION

Non-U.S. practitioners should be aware of the thin capitalization debt rules when planning for multinational structures. This can be particularly acute when the non-U.S. parent company is taxed in a jurisdiction that has a low to non-existent tax rate for the taxation of interest income and the planner seeks to reduce U.S. taxable income through an interest deduction.

The concern regarding thinly capitalized entities and interest deduction also exists within the B.E.P.S. framework. Action 4 discusses several solutions to the problem, including recharacterizing the interest payment as a dividend and using a carry-forward rule that is similar to the one found in U.S. At the same time, Action 4 expands on the number of prohibited transactions by introducing the concept of "interest equivalents." Like the U.S., the B.E.P.S. framework includes the concept of "guarantees in financial arrangements" as an interest equivalent. However, it also includes several other interest equivalents not present in the U.S. tax code, *inter alia* derivative instruments and Islamic finance transactions.[14]

Practitioners should also be aware that the I.R.S. Large Business & International ("LB&I") Division has released a step-by-step plan to assist auditors when analyzing interest payments that may implicate Code §163(j).[15] When reviewing the interest expense computation, the I.R.S. will review Forms 8926 and 1120, as well as the taxpayer's ledgers, financial statements, and other tax return statements. Practitioners should review the I.R.S. plan with respect to clients making loans involving related parties, so that they may prepare the correct documentation accordingly.

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14 Stanley C. Ruchelman and Sheryl Shah, "B.E.P.S. Action 4: Limit Base Erosion via Interest Payments and Other Financial Payments," *Insights* 1 (2015).

15 I.R.S., "LB&I International Practice Service Process Unit – Audit," last updated January 6, 2016.

TAX HOME V. ABODE – ARE THEY THE SAME FOR CODE §911 PURPOSES?

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Tags
Abode
Code §911
Foreign Earned Income
Tax Home

INTRODUCTION

The Internal Revenue Code (the "Code") provides a foreign earned income and housing cost exclusion to qualified individuals, subject to some limitations set out in Code §911(b)(2). Generally, a U.S. taxpayer can elect to exclude foreign earned income from gross income if (i) the taxpayer is an individual whose tax home is in a foreign country, and (ii) the taxpayer is either a *bona fide* resident of one or more foreign countries or physically present in such country or countries during at least 330 days in a 12-month period.[1] An individual cannot have a tax home in a foreign country for any period for which an abode is maintained within the U.S.[2]

In *Qunell v. Commr.*,[3] the Tax Court addressed the meaning of tax home under Code §911 in a summary opinion, and highlighted the difference between the terms *tax home* and *abode*. Even though the summary opinion issued by the court cannot be used as a precedent for other cases, the decision should be considered by taxpayers and their tax advisors when they are seeking to structure their affairs to take advantage of the exclusion.

FACTS

After 17 years of active service in the U.S. Army, Mr. Qunell began working for AECOM Technology ("A.E.C.O.M.") as an atmospheric manager in Afghanistan on July 7, 2010. His assignment related to a contract that A.E.C.O.M. held with the U.S. Department of Defense ("D.O.D.").

His employment with A.E.C.O.M. lasted approximately one year and four months. During that time, Mr. Qunell lived on a U.S. military facility in Kabul, Afghanistan. According to his passport, during 2011 he left Afghanistan from time to time for vacations and to travel to the U.S. to get married. A short time after the wedding, Mr. Qunell returned to Afghanistan without his wife.

During the 2011 calendar year, Mr. Qunell and his wife owned a house in Illinois. His wife and their children lived in the Illinois home and were Illinois residents, while Mr. Qunell was working in Afghanistan. Neither his wife nor any of their children visited him while he was in Afghanistan. Mr. Qunell also maintained several U.S. bank accounts.

On November 18, 2011, due to a disagreement with A.E.C.O.M., Mr. Qunell resigned.

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1 Code §911(d)(1).

2 Code §911(d)(3).

3 *Qunell v. Commr.* T.C. Op. 2016-86 (Dec. 19, 2016).

Mr. Qunell wanted and believed that he was entitled to an assignment in the U.S. He was unemployed from the time he left A.E.C.O.M. until he returned to the U.S. Army in July 2012.

Mr. Qunell's 2011 Federal income tax return was filed on November 5, 2013, after he was notified that the I.R.S. was preparing a 2011 substitute return. His tax return included Form 2555, *Foreign Earned Income*, where he disclosed the wages he earned from A.E.C.O.M. while employed in Afghanistan. Based on Code §911(a), he took the position that his *tax home* was in Afghanistan, and excluded those wages from the income otherwise reported on that return. The Tax Court accepted his claim that he did so upon the advice he received through a service offered by the Army and a recommendation made by an acquaintance who professionally prepared Federal income tax returns.

Accordingly, the I.R.S. determined that Mr. Qunell was not entitled to the Code §911(a) foreign earned income exclusion for the 2011 tax year. The I.R.S. further determined that the taxpayer was liable for the additions to the tax under Code §§6651(a)(1) and (2), and for the accuracy-related penalty under Code §6662(a) on various grounds.

ANALYSIS

U.S. citizens and tax residents are taxed on their worldwide gross income unless a specific exclusion applies.[4] Gross income means "all income from whatever source derived."[5] One of the exclusions available to the taxpayer is the foreign earned income exclusion, which is provided for a "qualified individual" subject to some limitations which are set out in Code §911(b)(2). To be entitled to this exclusion, a taxpayer must satisfy two requirements:[6]

- The taxpayer must be an individual "whose tax home is in a foreign country."
- The taxpayer must either be a "bona fide resident" of one or more foreign countries, or be physically present in such country or countries during at least 330 days in a 12-month period.[7]

In this case, the court considered whether the petitioner's *tax home* during 2011 was in Afghanistan. Code §911(d)(3) refers to Code §162(a)(2) for the definition of the term *tax home* in the case of an individual. Under Code §162(a)(2), a person's home is generally considered to be the location of his regular or principal place of business.[8] However, Code §911(d)(3) goes on to provide that "[an] individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States." That is, an individual whose *abode* is within the U.S. cannot establish that his or her *tax home* is in a foreign country.[9]

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4 *Specking v. Commr.*, 117 T.C. 95, 101102 (2001); *Haessly v. Commr.*, 68 F. App'x 44 (9th Cir. 2003).

5 Code §61(a).

6 Code §911(a).

7 Code §911(d)(1).

8 *Mitchell v. Commr.*, 74 T.C. 578, 581 (1980).

9 *Jones v. Commr.*, 927 F.2d 849, 856 (5th Cir. 1991); *Harrington v. Commr.*, 93 T.C. 297, 307 (1989).

In *Bujol v. Commissioner*,[10] when considering the meaning of the word *abode* as used in Code §911(d)(3), the Tax Court pointed out that *abode* has been traditionally defined as one's home, habitation, residence, domicile, or place of dwelling. While an exact definition of *abode* depends upon the context in which the word is used, it clearly does not mean one's principal place of business. Thus, *abode* has a domestic (or personal) rather than vocational meaning, and stands in contrast to *tax home* as defined for the purposes of Code §162(a)(2).[11]

"According to the Tax Court, a taxpayer's abode is generally in the country in which the taxpayer has the strongest economic, familial, and personal ties."

According to the Tax Court, a taxpayer's *abode* is generally in the country in which the taxpayer has the strongest economic, familial, and personal ties.[12] During 2011, Mr. Qunell owned a home in Illinois where his wife and children lived and he maintained bank accounts in the U.S. He lived on a military facility in Kabul, Afghanistan, his family did not visit him there, and nothing in the record suggests that he traveled within Afghanistan other than as required by his employment. Moreover, he terminated his employment with A.E.C.O.M. because he wanted to return to the U.S.

His ties to Afghanistan were entirely transitory and did not extend much, if at all, beyond the bare minimum required to perform his duties there. Other than the location of his employment, Mr. Qunell had not established that he had any economic, familial, or personal ties to Afghanistan. The Tax Court was satisfied that Mr. Qunell's economic, familial, and personal ties to the U.S. were sufficiently strong to consider the U.S. to be the location of his *abode* at all times relevant here. Therefore, the wages he earned in Afghanistan during 2011 were not excludable from his income under Code §911(a).

Accordingly, the *tax home* and *abode* are two different things, the taxpayer may have a *tax home* in a foreign country, but if he maintains closer ties with the U.S. for purpose of Code §911, he will not be able to utilize the foreign earned income exclusion. In light of this decision, taxpayers relying on the foreign earned income exclusion should make sure they develop closer ties to the foreign country to claim the foreign earned income exclusion.

It is unclear if this decision will have any effect on Code §865. Code §865(g)(1)(A)(i) defines the term "United States resident" to include any U.S. citizen or resident alien individual who does not have a *tax home* in a foreign country.[13] The term "United States resident" also includes any nonresident alien individual who has a *tax home* in the U.S.[14] For this purpose, *tax home* has the same meaning as in Code §911(d)(3).[15] Generally, gain from the sale or exchange of personal property is U.S.-source income with respect to a U.S. resident seller, and foreign-source income with respect to a non-U.S. resident seller.[16] If the court's opinion is extended to Code §865, it can create new planning opportunities for individuals with cross-border transactions.

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10 *Bujol v. Commr.*, T.C. Memo. 1987230, 53 T.C.M. (CCH) 762, 842 F.2d 328 (5th Cir. 1988).

11 *Id.*

12 *Id.*; *Jones v. Commr*.

13 Code §865(g)(1)(A)(i)(I).

14 Code §865(g)(1)(A)(i)(II).

15 Code §865(g)(1)(A).

16 Code §865(a).

CONCLUSION

As demonstrated by this recent Tax Court case, taxpayers seeking to take advantage of the foreign earned income exclusion must understand that simply working abroad does not ensure they can rely on this exclusion.

Taxpayers should sit down with their tax advisors and their families to determine the steps required to take advantage of this exclusion. In doing so, they must weigh the benefits against the costs of a possible disruption in their lives, and in the lives of their families, to ensure that a tax choice is the right one to make.

LB&I AUDIT INSIGHTS: USING A CODE §6038A SUMMONS WHEN A U.S. CORPORATION IS 25% FOREIGN OWNED

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Tags
Audit Guidance
Foreign Ownership
International Practice Unit
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Reporting Requirements
Summons

INTRODUCTION

On January 30, the I.R.S. Large Business and International ("LB&I") Division published an international practice unit ("I.P.U.") outlining the steps its auditors should take when issuing a recordkeeping and reporting summons to a U.S. corporation that is 25% owned by a foreign shareholder.[1] More importantly, the I.P.U. advises I.R.S. examiners on steps to be taken when the response to the summons is viewed to be incomplete.

BACKGROUND

Under Code §6038A and subject to certain exceptions, a domestic "reporting corporation" that is 25% or more foreign-owned (a "D.R.C.") must provide the I.R.S. with information on certain transactions with the 25% foreign owner and any other foreign party that is related to the 25% foreign owner. The information is provided on Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*.

Pursuant to regulations promulgated under this provision,[2] a D.R.C. must maintain records that may be relevant to determine the correct U.S. tax treatment of transactions with foreign related parties. Determining the correctness of the D.R.C.'s Federal income tax return may require the I.R.S. to examine data that is in the custody or control of a foreign related person. Generally, a summons issued by the U.S. government to a foreign person is not legally enforceable when that person resides in a foreign country.

For that reason and to ensure enforcement of record requests, Code §6038A(e) provides that the D.R.C. may be designated by a foreign related person as its agent to receive I.R.S. requests and summonses for records.[3]

The I.P.U. acknowledges that exceptions are provided for small corporations and transactions of *de minimis* value. A D.R.C. with less than $10 million of U.S. gross receipts in a tax year is not required to be authorized as an agent for that tax year. In addition, a D.R.C. with gross payments to and from foreign related parties of not more than $5 million and less than 10% of its U.S. gross income for a tax year is not required to be authorized as an agent for that year.

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1 See "Practice Units."

2 Subject to the small corporation exception of Treas. Reg. §1.6038A-1(h) and the safe harbor for reporting corporations with related-party transactions of *de minimis* value of Treas. Reg. §1.6038A-1(i).

3 Once a foreign related party designates a D.R.C. as a limited agent, that authorization is effective for all tax years not barred by the statute of limitations.

When the foreign related party does not designate the D.R.C. as agent, or when the D.R.C. fails to substantially comply[4] in a timely manner with an I.R.S. summons to produce records or take testimony, a noncompliance rule may be triggered.[5] The rule penalizes the D.R.C. by increasing its tax in a dramatic fashion. Deductions related to the transaction under examination may be disallowed. In addition, the price of property that is purchased by the D.R.C. from a foreign related party may be removed from cost of goods sold. The same enforcement rule applies when the D.R.C. purchases inventory for sale to a foreign related party. By ignoring purchases, the entire sales price will constitute gross income.

"If the U.S. disregarded entity does not generate effectively connected income for its sole foreign member, the enforcement tools to incentivize compliance may not be effective."

The I.P.U. advises examiners that the I.R.S. has sole discretion to determine the amount of the adjustment. In so doing, the I.R.S. may base its adjustments on its own knowledge and belief, and on information it chooses to obtain through testimony or otherwise. The I.R.S. may disregard any information or materials submitted by the D.R.C. or a foreign related person if the I.R.S. deems such information or materials insufficiently probative of the relevant facts. The adjustment, known as the noncompliance penalty, can be overridden only by clear and convincing evidence that the I.R.S. abused its discretion.

ISSUING A SUMMONS

Before issuing a summons, the examiner is encouraged to consider whether a treaty procedure can be used efficiently to obtain information. If records are obtainable within 180 days of an information exchange request pursuant to a tax treaty or tax information exchange agreement ("T.I.E.A."), the I.R.S. will generally turn to this resource first. The absence or pendency of a treaty or T.I.E.A. request is not grounds for a D.R.C. to refuse to comply with a summons and is not a defense against the noncompliance penalty.

Issuing a summons is permitted when the following criteria are met:

- The taxpayer under exam is a D.R.C.
- A transaction occurred between the D.R.C. and its 25% foreign shareholder or any foreign person related to the D.R.C. or to such 25% foreign shareholder.
- The D.R.C. is appointed to act as a limited agent with respect to any request by the I.R.S. to examine records or produce testimony that may be relevant to the tax treatment of any transaction between the D.R.C. and a foreign related party.

Pursuant to recently issued final regulations, a U.S. disregarded entity wholly owned by a foreign person is treated as a domestic corporation for the limited purpose of the reporting, record maintenance, and associated compliance requirements. Thus, such entities are included in the definition of a D.R.C. for purposes of issuing a summons.[6] If the U.S. disregarded entity does not generate effectively connected

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4 This is a facts and circumstances matter. The importance of the foreign-based documentation provided, not the number of documents or the proportion of the answered sections, govern.

5 Note that the I.R.S. must first notify the D.R.C., by certified or registered mail, that it has not substantially complied with the summons.

6 The exceptions from record keeping and designation as agent of the foreign

income for its sole foreign member, the enforcement tools to incentivize compliance may not be effective. Gross income may be zero before deductions and cost of goods sold are disallowed. However, the noncompliance penalty is only one type of enforcement tools available for the I.R.S. A monetary penalty applicable to the failure to timely file a complete and accurate Form 5472 and the failure to maintain and produce records may be imposed.

If a foreign related party is not a party to a properly executed agent authorization that appoints the D.R.C. to act as a limited agent, the I.R.S. may not issue a summons. Further, the I.R.S. may not issue a summons if the D.R.C. is excused from being designated as an agent pursuant to the small corporation exception or a *de minimis* safe harbor rule.

ENFORCEABILITY OF A SUMMONS

Generally, a court will enforce a summons if the following criteria are met:

- There is a legitimate purpose for the investigation.
- The material sought is relevant to that purpose.
- The material sought is not already within the I.R.S.'s possession.
- The administrative steps required by the Code have been taken.

Regarding the relevance of the material sought, the I.R.S. has the authority to examine any information that may be relevant to ascertain the correctness of a return, make a return when none was made, or determine the proper tax liability. Under a widely-accepted standard of relevance, information is relevant if it might have thrown light upon the correctness of the return.[7] However, there should be a realistic expectation that this information will lead to a discovery. An idle hope is not sufficient for a summons to be enforced.[8]

Relevant records include books, papers, electronic records, and other data of D.R.C. and any foreign related party that may be relevant or material to determine the correct U.S. tax treatment of a transaction.

JUDICIAL PROCEEDINGS

The I.P.U. recognizes that a D.R.C. may begin judicial proceedings in a U.S. district court to quash a summons. The motion must be filed within 90 days from the date on which the summons was issued.[9] In general, a motion to quash a summons is one of the more frequently litigated taxpayer issues and one on which the I.R.S. has an excellent record of success. The Taxpayer Advocate Service, which tracks most litigated issues and submits an annual report to Congress, recorded that in

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related party, which apply to U.S. corporations meeting the small corporation exception or the *de minimis* safe harbor rule, are not available to disregarded entities.

7 *Foster v. U.S.*, 265 F.2d 183 {2nd Cir. 1959).

8 *U.S. v. Harrington*, 388 F.2d 520 (2nd Cir. 1968).

9 *ASAT Inc. v. U.S.*, 76 AFTR2d 957821 (N.D. Cal.1995).

the 12-month period ending on June 30, 2014, 102 cases were brought by taxpayers or the I.R.S. to enforce or quash a summons. The I.R.S. prevailed in full in 97 cases, a 95% success rate. In the comparable period ending in 2015, 84 cases were brought, and the I.R.S. prevailed in full in 81 cases. It should be noted that more than two-thirds of the cases were brought by persons not represented by legal counsel.

The D.R.C. may also begin a judicial proceeding in U.S. district court to review an I.R.S. determination that the D.R.C. did not substantially comply with a summons. The proceedings must begin within 90 days from the day the notice of noncompliance was mailed. If not so appealed, the I.R.S. determination is binding and cannot be reviewed by any court.

CONCLUSION

On January 31, LB&I announced initial compliance campaigns, which included the Related-Party Transaction Campaign. The examination approach identified for that campaign reflects LB&I's transition towards issue-based examinations.

During the course of an examination, the I.R.S. will likely make a request for information regarding the control of a foreign related party when examining a D.R.C. It may even wish to examine the books and records of the foreign party that is related to the D.R.C. Although, the I.P.U. was not identified as an examination approach of this campaign, the issues are directly related and it is expected that a summons issued under Code §6038A will be a tool used by the international examiner in a contentious fact pattern.

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Tags
CbC Reporting
China
Code §385
France
Tax Compliance
Tax Reform

FOREIGN TRUST DISCLOSURE PENALTIES PARTLY HELD UNCONSTITUTIONAL IN FRANCE

Last December, the French Administrative Court (*Conseil d'Etat*) requested a Constitutional Court (*Conseil Constitutionnel*) ruling on whether penalties imposed under Article 1736, IV bis of the French Tax Code violate the French Constitution.[1] On March 16, 2017, the Constitutional Court returned its ruling, confirming that certain penalties were unconstitutional.

Trustees of a trust with a connection to France are required to disclose the creation of the trust instrument, the names of the settlors and the beneficiaries, as well as the terms of the trust and any amendments made to it. Article 1736, IV bis states that the penalty for non-disclosure is equal to the greater of €20,000 or 12.5% of the assets, rights, and capitalized incomes for disclosures of non-compliance made on or after December 6, 2013, or the greater of €10,000 or 5% of the assets, rights, and capitalized incomes for disclosures made prior to that date.

In its ruling, the Constitutional Court held that the 5% and 12.5% penalties, which are not capped, are disproportionate to the seriousness of the failure. However, the court decided that the fixed penalties of €10,000 or €20,000 should remain applicable since they are not disproportionate to the purpose of combatting offshore tax evasion.[2] The decision takes effect as of the date of its publication and cannot be a used in cases already closed.

EXECUTIVE ORDER CALLS FOR DEREGULATION, PLACES DOUBT ON OBAMA-ERA PROTOCALS

On April 21, 2017, President Trump issued an executive order calling on the Treasury Department to review "all significant tax regulations" issued in 2016 and provide recommendations with eye toward simplifying the Federal tax system.[3] Items slated for review include all regulations that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the I.R.S. The Treasury has been granted 150 days in which to prepare its recommendations.

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1 Astrid Champion and Nina Krauthamer, "Updates & Other Tidbits," *Insights* 2 (2017).

2 French Constitutional Court, QPC 2016-618, March 16, 2017.

3 The White House, Office of the Press Secretary, Presidential Executive Order on Identifying and Reducing Tax Regulatory Burdens, April 21, 2017.

The order places doubt on the future of significant Obama-era regulations, particularly the revised regulations under Code §385, which address whether a debt instrument will be treated as true debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity. During a contentious 6-month consultation proccess, these regulations met with staunch resistance from U.S. buinesses and lawmakers, which led to a significant scaling back in the final regulations.

The order appears to be the first step in a broader push by the Trump Administration to refocus its efforts on tax reform after the defeat of the initiative to repeal and replace Obamacare. Speaking with the Associated Press over the weekend, President Trump revealed that his tax reform package is expected to be released on Wednesday, April 26, and will include "a massive tax cut . . . maybe the biggest tax cut we've ever had."[4]

COUNTRY-BY-COUNTRY REPORTING – GUIDANCE ON FORM 8975

As a follow-up to regulations issued last June,[5] the I.R.S. recently released draft instructions[6] to draft Form 8975, which must be filed annually by the ultimate parent entity of a U.S. multinational enterprise ("U.S. M.N.E.") in accordance with Country-by-Country ("CbC") reporting requirements.

While filing requirements generally apply to tax years beginning on or after June 30, 2016, some foreign jurisdictions have adopted CbC reporting rules for annual periods beginning on or after January 1, 2016. In certain cases, these provisions would require an entity in that jurisdiction to report CbC information if it is part of an U.S. M.N.E. group in which the ultimate parent resides in a jurisdiction without CbC reporting requirements for the same annual accounting period. Rev. Proc. 2017-23, issued on January 19, 2017, provides that the ultimate parent of a U.S. M.N.E. may choose to voluntarily file Form 8975 and the accompanying Schedule A for reporting periods beginning after January 1, 2016, and before June 30, 2016.

Globally, a U.S. M.N.E. must disclose the group's business entities, indicate each entity's tax jurisdiction, country of organization, and main activity, as well as provide financial and employee information for jurisdictions in which the U.S. M.N.E does business, on Form 8975, *Country-by-Country Report*, and Schedule A, *Tax Jurisdiction and Constituent Entity Information*. Form 8975 is divided into three parts. The first part deals with the basic identifying information of the filer, whereas the second part is optional and provides a space for any additional information about the group. A "stateless" constituent (*i.e.*, an entity that does not have a tax jurisdiction of residence) must be reported on Schedule A along with a description of the business activity carried on.

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4 "AP Interview with Trump," interview, AP News, April 24, 2017.

5 The U.S. Treasury Department and the I.R.S. published final regulations on June 30, 2016, in the form of Treas. Reg. 1.6038-4, which requires the ultimate parent entity of a U.S. M.N.E. group to report CbC information for a relevant reporting period if the annual revenue of the U.S. M.N.E. group for the prior reporting period was greater than $850,000,000.

6 Rev. Proc. 2017-23.

The U.S. M.N.E must attach Form 8975 and Schedule A to its income tax return. Beginning on September 1, 2017, Form 8975 may be filed for an early reporting period with the income tax return or other return as provided in the instructions to Form 8975 for the taxable year of the ultimate parent entity of the U.S. M.N.E. group with or within which the early reporting period ends. To file Form 8975 for an early reporting period, an ultimate parent entity that files (or has filed) an income tax return for a taxable year that includes an early reporting period without a Form 8975 attached must follow the procedures for filing an amended income tax return and attach Form 8975 to the amended return within 12 months of the close of the taxable year that includes the early reporting period. Filing an amended income tax return solely to attach Form 8975 in accordance with this revenue procedure will have no effect on the statute of limitations for the income tax return.

CHINA OFFERS TAX BREAKS FOR MID-SIZED COMPANIES

Following complaints regarding high tax burdens, the Chinese government announced the introduction of several tax breaks in its annual "Government Work Report." The changes are mainly related to corporate taxation.

The government will provide a 50% reduction in the corporate income tax rate for companies realizing taxable profits up to 500,000 yuan ($72,300 U.S.D.) per taxable year. This is an increase from the current threshold of 300,000 yuan ($43,400 U.S.D.) allowing more companies to benefit from the new measure.

Also, the government plans to remove one of the four tax brackets of the V.A.T. scale.

To further the development of a high-tech and innovation-driven economy, the government will increase the R&D deduction from corporate income tax from 50% to 75%. In order to qualify for this benefit, small and mid-sized companies must be registered as technology companies with China's tax authorities. Regulations, including guidelines and definitions, are expected to be issued in the following weeks.

These measures parallel an array of tax policies introduced last year to encourage economic reform. Under the 13th Five-Year Plan, China now offers tax benefits to "foreign-invested R&D centers"[7] and import items used for scientific research, technology development, and teaching that cannot be produced, or adequately produced, by domestic suppliers are exempt from customs duties and import V.A.T.[8]

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7 Ministry of Finance, *Circular on Import Taxation Policies for Supporting Scientific Innovation during the "Thirteenth Five-Year-Plan" Period*, (December 27, 2016), art. 2, §7.

8 *Id.*, art. 1.

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