UPDATES & OTHER TIDBITS

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CHANGES IN CHINA'S TAX LAW AFFECT FOREIGN NATIONALS

As of last September, China has begun sharing taxpayer financial information of residents and nonresidents with over 100 countries under the Common Reporting System ("C.R.S."). In addition, on August 31, 2018, China revised its Individual Tax Law ("I.T.L.") and introduced anti-tax avoidance provisions. These provisions are designed to enable tax authorities to tax people who transfer assets in order to evade tax or take advantage of tax havens.

The I.T.L. will affect many foreign nationals living in mainland China (including those that commute to Hong Kong). Currently, China taxes a foreign non-domiciled individual on worldwide income if the individual has resided in mainland China for one year. However, starting on January 1, 2019, individuals who do not have a domicile but reside in China for 183 days or more in a tax year will be considered tax residents. This rule has come under huge criticism, and waivers or exemptions are being sought, particularly for foreign persons recruited under government programs.

It is expected that China will allow certain exceptions to the 183-day test. The law may continue to exempt foreign individuals who spend extended time outside of China. Furthermore, the new 183-day rule may commence only in the sixth year of residency. Nonetheless, foreigners that meet the 183-day test may still be subject to C.R.S. exchange of information.

DRAFT ECONOMIC SUBSTANCE LEGISLATION FOR CROWN DEPENDENCIES

Three Crown Dependencies exist: the Isle of Man in the Irish Sea, the Channel Island of Jersey, and the Channel Island of Guernsey in the English Channel. Crown dependencies are self-governing jurisdictions of the Crown. The U.K. government has the power to pass legislation that affects Crown Dependencies because they are not considered to be sovereign states. Nonetheless, each of the legislative assemblies maintains the power to pass laws that affect them locally.

In late 2018, the Crown Dependencies published draft legislation requiring adequate economic substance for resident companies carrying on certain activities. Once enacted, a company that is resident in one of the three jurisdictions will not be considered to have economic substance in the jurisdiction unless the core activities of the company occur in the jurisdiction, management and direction take place in the jurisdiction, and adequate employees, expenditures, and physical presence exist in the jurisdiction.

Note that management and direction is not the same as management and control. The latter relates merely to the place where the board of directors meet. The former relates to the types of decisions that are made at the meetings of the board of directors. The directors must have sufficient knowledge and expertise, and the decisions must be made at meetings that take place in the Crown Dependency with adequate frequency.

The rules will apply to companies that are resident in a Crown Dependency and that conduct any of the following business activities:

- Banking
- Insurance
- Shipping
- Fund management
- Financing and leasing
- Headquartering
- Operation of a holding company
- Holding intangible property
- Distribution

The open question not yet addressed in the draft legislation is the definition of economic substance once the necessary factors exist. The Crown Dependencies have announced that guidance notes will be issued on this point. If experience with attempts to define economic substance in other jurisdictions holds true, the guidance notes may well resemble an art critic's attempt to define the *Mona Lisa* in "art speak." Many words will be used to describe the obvious without conveying an understanding of the soul of the subject.

FOREIGN EARNED INCOME EXCLUSION DENIED: ABODE WAS IN THE U.S.

A question that arises for clients that work outside the U.S. on a periodic basis is whether the foreign earned income exclusion applies to salary payments. Where a taxpayer is based in a low-tax or no-tax jurisdiction, the exclusion provides more attractive benefits than a foreign tax credit. In *Leuenberger v. Commr.*,[1] the Tax Court was asked to examine whether a military contractor working in Afghanistan qualified for the exclusion. On the basis of existing authority, the court held that the exclusion was not available in the facts presented.

The taxpayer worked full time as an aircraft pilot for Berry Aviation, Inc. He split his time in rotational shifts between the U.S. and Bagram Air Base in Afghanistan. While in Afghanistan, he piloted a Dehaviland DHC-8 aircraft in support of the U.S. Armed Forces. His employment agreement called for him to work for 60 days on in

[1] T.C. Summary Opinion 2018-52.

Afghanistan followed by 60 days off in the U.S. In 2012, the taxpayer worked outside the U.S. for 173 days and in 2013 for 203 days.

When on deployment, the taxpayer was furnished governmental housing, meals, and transportation, among other services. During the petitioner's time in Afghanistan, Bagram Air Base was susceptible to regular hostilities or attacks. He rarely left the base during his stays in Afghanistan and had no investments in that country. In comparison, throughout 2012 and 2013, the taxpayer maintained a residence in the U.S. in Vancouver, Washington. During these years the petitioner had family in the U.S. and owned and registered three vehicles in the State of Washington. Additionally, he had bank accounts at Wells Fargo Bank and maintained brokerage and retirement accounts at First Trust Co. of Onaga, Jackson National Life Insurance Co., and Pershing, LLC. In 2013, the petitioner owned and maintained a residential rental property in Lake Stevens, Washington, and a residential complex in Monroe, Washington.

Citizens of the U.S. are taxed on worldwide income unless a specific exclusion applies. Code §911(a)(1) provides that a qualified individual may elect to exclude foreign earned income, subject to certain limitations. To be a qualified individual, a taxpayer must satisfy two requirements:

- 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 during at least 330 full days in a 12-month period.[2]

As the taxpayer was not a *bona fide* resident of another country, to be a qualified individual for purposes of the exclusion, he was required to meet the tax home and the physical presence requirements. Code §911(d)(3) defines the term "tax home" as an individual's home for purposes of Code §162(a)(2), involving the allowance of deductions for expenses incurred while traveling travel away from "home," *e.g.* on a business trip. For that purpose, a person's tax home is generally considered to be the location of their regular or principal place of employment. Nonetheless, an individual is not treated as having a tax home in a foreign country for any period for which the person's abode is within the U.S. Although the term "abode" is not defined in the statute or the regulations, Tax Court decisions have held that it generally means the country in which the taxpayer has the strongest economic, familial, and personal ties.

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The facts in the case indicated that the taxpayer performed his work regularly and principally in Afghanistan. The facts also indicated that his abode was within the U.S. because his ties to the U.S. were stronger than his ties to Afghanistan, where he rarely left Bagram Air Force Base. He had no connection with Afghanistan other than the location of his employment. Because the taxpayer did not satisfy the tax home requirement, he did not qualify for the foreign earned income exclusion.

The taxpayer argued that he could not meet the tax home requirement because conditions in Afghanistan were unsafe in light of the ongoing military conflict in the country. In support, the taxpayer pointed out that the statute allows the tax home requirement to be waived when the I.R.S. determines that an individual is required to leave a country because war, civil unrest, or similar adverse conditions preclude

[2] Code §911(d)(1).

the normal conduct of business and, but for those conditions, the individual could be expected to meet the day-count requirements. However, the court determined that the waiver was not applicable in these circumstances. Each year, the I.R.S. publishes a list of countries to which the waiver applies. During the years involved in the case, Afghanistan was not on the list. Even if Afghanistan were listed, the contract between the taxpayer and his employer called for 60 days on assignment in Afghanistan and 60 days off in the U.S. That was the principal reason why the taxpayer was not outside the U.S. for 330 days in any 12-month period.

RESIDENCY CERTIFICATE – FEE INCREASE ANNOUNCED

The user fee for Form 8802 increased from $85 to $185 for non-individual taxpayers on December 1, 2018. Form 8802 is the form used to request residency certification from the I.R.S. In many countries, payments of dividends, interest, and fees made to a U.S. resident are subject to withholding tax at domestic rates unless Form 6166 is issued by the I.R.S., certifying to the tax residence of the U.S. recipient.

Form 8802, *Application for U.S. Residency Certification*, is used to request Form 6166, *Certification of U.S. Tax Residency*, a letter that the applicant may use as proof of U.S. residency when claiming benefits under an income tax treaty or an exemption from a value added tax imposed by a foreign country. Applicants that are fiscally transparent for U.S. Federal tax purposes, such as partnerships, S-corporations, and grantor trusts, may request certification based on the status of their partners, shareholders, owners, or beneficiaries.

Among other requirements, Form 8802 requires the applicant to specify its taxpayer identification number and, in the case of applicants that are fiscally transparent entities, the identification number of each of the applicant's partners, shareholders, owners, or beneficiaries. Form 8802 also requires the applicant to specify the country or countries for which certification is requested. As a result, not all certification letters on Form 6166 are identical.

In Rev. Proc. 2018-50, the I.R.S. announced that the fee due at the time of filing Form 8802 has been increased for applicants that are not individuals. The fee moves from $85 to $185 for applicants other than individuals. The Form 8802 user fee is not refundable except in cases of overpayment due to mathematical error or mistake.

The current fee schedule is as follows:

- **Requests by Individual Applicants.** A user fee of $85.00 per Form 8802 will continue to be charged for a request by an individual applicant, regardless of the number of countries for which certification is requested or the number of tax years to which the certification applies:
- **Requests by Applicants Other Than Individuals.** A user fee of $185.00 per Form 8802 will be charged for a request by each non-individual applicant:
- **Fiscally Transparent Entities.** A partnership, S-corporation, grantor trust, or other fiscally transparent entity will be charged a single $185.00 user fee with respect to all Forms 6166 issued under its EIN, notwithstanding that the

I.R.S. will verify the tax status of each of the partners, owners, or beneficiaries of the entity who have consented to the request for certification:

- **Custodial Accounts.** A custodian requesting certification on behalf of an account holder will continue to be charged a user fee for each account holder tax identification number, with the amount charged based on the status of the account holder as an individual or non-individual applicant:

- **Multiple Requests.** Because any additional requests for Form 6166 submitted by an applicant on a separate Form 8802 will require the payment of an additional $85.00 or $185.00 user fee charge, an applicant is encouraged to include all Form 6166 requests relevant to a single Form 8802 to avoid multiple user fee charges.

Form 8802 may be submitted to the I.R.S. by mail, delivery service, or fax:

- If the form is submitted by mail, it should be addressed to Internal Revenue Service, P.O. Box 71052, Philadelphia, PA 19176-6052.

- If a private delivery service is used, the submission package should be sent to Internal Revenue Service, 2970 Market Street, BLN# 3-E08.123, Philadelphia, PA 19104-5016.

- If the form is submitted by fax, the user fee should be paid first and should be made by electronic payment at the Pay.gov website. The electronic payment confirmation number related to the payment should be inserted on Form 8802. Any of the following fax numbers should be used: (877) 824-9110, if within the U.S., and +1 (304) 707-9792, if inside or outside the U.S.

NEW MULTILATERAL WORKING RELATIONSHIP TARGETS ENABLERS OF TAX FRAUD

The year 2018 saw the establishment of a working group to combat transnational tax crime through increased enforcement collaboration among tax authorities in several countries. The Joint Chiefs of Global Tax Enforcement (known as the J5) was formed to work together to gather information, share intelligence, conduct operations, and build the capacity of tax crime enforcement officials. The J5 comprises the Australian Criminal Intelligence Commission ("A.C.I.C.") and Australian Taxation Office ("A.T.O."), the Canada Revenue Agency ("C.R.A."), the Dutch Fiscale Inlichtingen-en Opsporingsdienst ("F.I.O.D."), U.K. HM Revenue & Customs ("H.M.R.C."), and the U.S. Internal Revenue Service Criminal Investigation ("I.R.S.-C.I.").

The J5 was formed in response to the O.E.C.D.'s call to action for countries to do more to tackle the enablers of tax crime. The J5 works collaboratively with the O.E.C.D. and other countries and organizations where appropriate.

The 2018 annual report of I.R.S.-C.I. contains a statement by Eric Hylton, the Deputy Chief of I.R.S.-C.I.:

> This year, we established a new international tax and financial crime group in our Washington, DC, field office. This dedicated group of elite special agents works to identify, investigate, and recommend

prosecution of international offshore tax evasion schemes. The group looks at U.S. citizen account holders who move their money offshore to avoid detection, and at foreign banks, financial institutions, their employees, and facilitators who help U.S. citizens hide their funds offshore. This operational unit has the ability to work criminal tax cases developed from all international leads sources.

In addition to our international group, IRS CI recently formalized the creation of the Joint Chiefs of Global Tax Enforcement, or the J5. This group includes the heads of tax enforcement from the United States, the United Kingdom, Canada, Australia, and the Netherlands. These countries' leaders recognize the increasing trends in sophisticated tax evasion and other financial crimes that cross international borders, and they are already sharing information and collaborating on investigations.