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Inbound Update: Increasing Attention By I.R.S. To Foreign Taxpayers Doing Business In The U.S.

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Inbound Update: Increasing Attention By I.R.S. to Foreign Taxpayers Doing Business in the U.S.

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1. Conflicts Between Treaties and Domestic Law.

a. Interest Expense Regulations for Foreign Companies Held Inapplicable to Certain Foreign Banks.

National Westminster Bank v. U.S., ___Ct. Cl. ___ , (July 9, 1999, Docket No. 95-758), involves the methodology to compute the deduction for interest expense by foreign banks resident in countries with which the U.S. has income tax treaties in effect. The Court concluded that treaties mean what they say in connection with the treatment of permanent establishments, and as a result, the methodology adopted by the I.R.S. in regulations and rulings is not valid in the context of an applicable income tax treaty. The method remains valid for foreign banks resident in non-treaty jurisdictions.

The facts of the case are relatively straightforward. Natwest Bank is a resident of the U.K. and is entitled to the benefits provided by the U.K.-U.S. Income Tax Treaty ("the Treaty"). Natwest Bank maintained operations in the U.S. Because those operations constituted a permanent establishment, Natwest Bank was subject to tax in the U.S. on its business profits. As a financial institution, its business profits included interest income.

Natwest Bank's permanent establishment was funded in part by loans from branches of the bank located outside the U.S. These loans bore interest at market rates. During the years in issue before the Court, 1981 to 1987, Natwest Bank deducted the interest that accrued on the loans from the foreign branches when computing the taxable income of the U.S. permanent establishment. Its approach was premised on the business profits article of the Treaty, Article 7. Paragraph 2 of Article 7 provides in pertinent part that the taxable profits of a permanent establishment are:

> [T]he profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

Upon, audit, the I.R.S. determined that the method used by Natwest Bank was contrary to the regulations applicable to foreign corporations, Regs. §1.882-5. The regulation provides that the interest expense deduction of a U.S. branch of a foreign corporation must be determined under a regulatory formula that ignores interbranch interest income and expense. Instead, the method applies the worldwide debt-equity ratio of the foreign bank to the assets that produce effectively connected income. In this manner, "debt" can be determined for purposes of computing tax. The average rate of interest accrued by the U.S. branch on third party borrowings is applied to the "debt" computed under the formula. The result is deductible portion of worldwide interest allocable to U.S. operations, which may be greater or lesser than the actual amount of interest expense reported on the books of the U.S. branch.

The I.R.S. asserted that the regulations are consistent with a different provision of the business profits article of the Treaty. Paragraph 3 of Article 7 provides in pertinent part that the profits of a permanent establishment are to be determined by allowing as deductions:

> [T]hose expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole * * *."

Natwest Bank paid the tax and brought a claim for refund. Each side submitted a motion for summary judgement based its interpretation of the Treaty. The Court determined that the interpretation of the business profits article advanced by Natwest Bank was the better of the two positions. It therefore ruled in favor of Natwest Bank's motion for summary judgment.

In reaching its decision, the Court looked to the language of the O.E.C.D. Draft Double Taxation Convention on Income and Capital ("the O.E.C.D. Model") and the commentary to each of the articles thereof. The Treasury Department Technical Explanation of the Treaty which was prepared at the time the Treaty was submitted for Senate approval expressly stated that the business profits article is "based on" the counterpart provision in the O.E.C.D. Model. Similarly, the Report of the Senate Foreign Relations Committee stated that the provision is "substantially the same as" the provision in the O.E.C.D. Model. Consequently, the Court determined that it was proper to look to the commentary on the O.E.C.D. Model to understand the scope of Article 7 of the Treaty.

The commentary explains that the central directive of the business profits provision of the O.E.C.D. Model is that a permanent establishment is to be treated as a separate entity when dealing with its head office in business. The profits of the permanent establishment are to be determined in line with that directive so that prices prevailing in the ordinary market will control the income of the permanent establishment and the head office. Where the books of account of the permanent establishment reflect ordinary market conditions and are prepared in accordance with good business accountancy, the books and records should be used to ascertain the taxable profits of the permanent establishment. Where appropriate, concepts of arm's length treatment may be applied to ensure that the books and records accurately reflect market conditions.

The Court also looked at a provision of the commentary applicable to a provision not in Article 7 of Treaty. It provides that formulary apportionment of the worldwide profits of an enterprise is to be avoided because it does not reflect the arm's length concept that applies to the determination of the taxable profits of a permanent establishment. According to the Court, this view reflects a basic tenet of the separate entity treatment mandated by the business profits article.

This is the third instance in recent years in which the commentary to the O.E.C.D. Model has been relied upon by a U.S. Court to determine the meaning of a particular treaty provision. The first was Taisei Fire & Marine Ins. Co., Ltd. v. Commr., 104 TC 535 (1995), involving the definition of the term "permanent establishment" in the context of an insurance company and a broker in the U.S. The I.R.S. argued that an unrelated insurance broker in the U.S. that represented four unrelated Japanese insurance companies was not an independent agent acting in the course of its business because the Japanese companies negotiated limits to the grant of authority given the broker and because the fees paid by the Japanese companies provided the broker with guaranteed profitability. In interpreting the treaty definition of the term independent agent, the Tax Court looked to the O.E.C.D. Model.

> Our examination shows that the relevant provisions of the Convention are not only based upon, but are duplicative of, article 5, comments 4 and 5, of the 1963 O.E.C.D. Draft [Model] Convention (hereinafter referred to as the 1963 Model).

The second case was The North West Life Assurance Co. of Canada v. Comm., 107 TC 363 (1996), involving the computation of investment income of an insurance company that is properly treated as effectively connected to a U.S. permanent establishment. The I.R.S. argued that provisions of U.S. tax law that mandate minimum yields should be applied to a U.S. permanent establishment of a Canadian insurance company. In ruling against the I.R.S., the Tax Court looked to the O.E.C.D. Model rather than accept the interpretation of the I.R.S. or the Treasury Department.

> The Senate's preratification materials confirm that the Canadian Convention was based in part on the Model Treaty. See S. Exec. Rept. 98-22 at 3. Our examination shows that the business profits article of the Model Treaty includes provisions substantially similar to Article VII, paragraphs (1) and (2) of the Canadian Convention. While the Model Treaty itself provides no more explanation than the Canadian Convention on how to determine the profits attributable to a permanent establishment, the Model is explained in part by the Model Commentaries. Petitioner relies upon paragraphs 10 and 13 of the Model Commentaries to Article 7, paragraph (2) of the Model Treaty in support of its contention that the separate-entity language of Article VII, paragraph (2) requires that taxable profits be attributed to a permanent establishment based on the establishment's facts. [Footnote deleted.]

Some commentators have expressed reservations on the wisdom of the case. They point to the fact that intracompany debt is not real debt and that the Court did not explain a helpful method of computing the notional capital of a branch in the U.S. They also point to the fact that the I.R.S. position has been in effect for a long period of time and should have been given greater credence. However valid these points may be, they ignore two important aspects of the case.

First, banks are different from most other entities in that the net of interest income and interest expense is the equivalent of gross margin from operations. Banks buy and sell money; to that extent, interest is the equivalent of cost of goods sold for a bank. The O.E.C.D. Model commentary recognizes that fact by excluding banks from the ordinary treatment of interest and royalty expense. According to the O.E.C.D. Model commentary, companies other than banks must apportion third-party interest expense to determine the net profits of a permanent establishment.

Second, an income tax treaty is a negotiated document by which two sovereign jurisdictions agree to the method under which cross border profits are to be taxed. The O.E.C.D. Model (along with the U.S. Treasury Model and the U.N. Model where appropriate) frequently serves as the basis for the compromises each side makes as to its taxing authority. The U.S. is a member of the O.E.C.D. It has commented and reserved on various portions of the O.E.C.D. Model. It has not reserved on the business profits article; and has not reserved on the special treatment afforded banks in the computation of net profits of a permanent establishment.

While the I.R.S. is fully authorized to provide for the treatment of interest expense under the method adopted by the regulations in the absence of a treaty that reflects the O.E.C.D. Model, once such a treaty exists, the relinquishment of tax authority is part of the compromises that are reflected in the document. If the I.R.S. believes that U.S. branches of banks should be required to apply Regs. §1.882-5 even in the context of a treaty based on the O.E.C.D. Model, it must so provide in the Treaty or at least reserve on the Business Profits Article.

In the recent past, the I.R.S. has obtained the tacit approval of the other jurisdiction to apply the regulatory method in the course of the treaty negotiations. This has apparently been done in recent treaties with Germany, Switzerland, France, Luxembourg, Mexico, Austria, and Ireland where the technical explanations of the Treasury Department explicitly reserve to the U.S. the right to apply Regs. §1.882-5. However, with the exception of Mexico, the reference to the regulations is silent regarding its application to banks. Indeed, the silence is deafening where the foreign country has a developed international banking industry with large branches in the U.S. The holding in National Westminster Bank is not inconsistent with the Treasury Department explanations – the former relates to banks while the latter relates to branches of other entities.

b. The requirement of domestic law that the timely filing of an income tax return is a prerequisite for the allowance of deductions is not overridden by a nondiscrimination provision of the Canada-U.S., Germany-U.S., and U.K.-U.S. Income Tax Treaties.

Technical Advice Memorandum 199941007 deals with the interplay of Code §882(c)(2) and Article XXV (Nondiscrimination) of the Canada-U.S. Income Tax Treaty. The Code provision mandates the filing of an income tax return as a prerequisite to claiming deductions. The treaty provision mandates that the taxation on a permanent establishment shall not be less favorably levied in the State where located than the taxation levied on residents of that State carrying on the same activities. Which controls when the I.R.S. determines that a Canadian corporation has been operating in the U.S. through a permanent establishment?

In the case, the I.R.S. conducted an examination of a U.S. corporation. In the course of the examination, it determined that the U.S. corporation had an affiliate in Canada that was engaged in a U.S. business through the U.S. corporation. Apparently, the U.S. corporation was a dependent agent that had and regularly exercised a power to bind the foreign corporation. Regs. §1.882-4 provides that a foreign corporation must file a tax return within 18 months after the due date of a return in order to claim the benefit of deductions. The actual operating expenses were not at issue; however, the examiner asserted that because the time period established in the regulations elapsed, no deductions could be claimed on the late filed return.

The National Office of the I.R.S. supported the assertion of the examiner, concluding that U.S. domestic law provided that the return was filed too late to claim the benefit of deductions and that nothing in the Canada-U.S. Income Tax Treaty mandated a different result. A "terminal point" point exists after which a taxpayer may no longer claim the benefit of deductions by filing a return. The provision should be viewed to be a negative incentive to encourage compliance with U.S. tax filing obligations. The terminal point is established in the regulations (18 months after the due date of a return) and the general principle has been affirmed by the Courts.

A corporation that conducts limited activities within the U.S. and determines that it has no gross income that is effectively connected with the conduct of a trade or business within the U.S., may file a protective return. The regulations acknowledge the function of a protective return; neither income nor expense is reported, and the foreign corporation and preserves the right to deduct expenses if a trade or business is conducted in the U.S.

In the facts before the I.R.S., no protective return was filed. The taxpayer argued that deductions should be permitted by the permanent establishment provision of the Canada-U.S. Income Tax Treaty. Paragraph 3 of Article VII (Permanent Establishment) provides that expenses incurred for the purposes of the permanent establishment should be deducted no matter where incurred. According to the taxpayer, the relationship between the expenses incurred in Canada and the income generated by the permanent establishment was clearly established. The mere fact that a return was filed late could not override the relationship and the right to a deduction.

The I.R.S. disagreed. In its view, the filing requirement is an administrative provision designed to prevent tax avoidance. Nothing in the Treaty precludes a State from imposing such administrative rules. Looking to the commentary to the O.E.C.D. Model Convention on Income and Capital, the I.R.S. stated that a contracting state should be free to use all methods at its disposal to fight fiscal evasion. Code §882(c) is enacted to prevent fiscal evasion. Such anti-abuse provisions are not affected by an the permanent establishment provision of an income tax treaty.

Finally, the foreign corporation argued that paragraph 6 of Article XXV (Nondiscrimination) of the Canada-U.S. Income Tax Treaty was violated by the I.R.S. According to the taxpayer, the denial of deductions was discriminatory because a U.S. domestic corporation would be allowed deductions under similar circumstances. The National Office of the I.R.S. concluded however, that for purposes of the allowance of deductions claimed by a foreign taxpayer, the circumstances of a permanent establishment could not be viewed to be similar to those of a domestic corporation. According to the I.R.S., the following factors distinguish a permanent establishment from a domestic corporation:

i. It is generally much more difficult for the I.R.S. to detect a noncompliant foreign corporation doing business in the U.S. than a noncompliant domestic corporation.

ii. Foreign corporations are only liable for tax on income attributable to the permanent establishment and can keep records regarding their U.S. activities entirely offshore.

iii. Foreign corporations may have little or no physical presence and few or no employees in the United States, particularly if they carry on their U.S. business through a dependent U.S. agent.

In other words, for purposes of applying an anti-abuse rule, a permanent establishment is in inherently different circumstances than those of a domestic corporation.

In a treaty context where the tax rates in the two jurisdictions are similar, the net effect of the I.R.S. position is the potential transfer of tax revenue from the other jurisdiction to the U.S. Treasury. Whether this position can withstand a challenge under the competent authority provisions is an open question. The I.R.S. position results in double taxation if the foreign corporation is a taxpayer in the treaty jurisdiction and the foreign authority does not agree with the disallowance. This aspect of the issue was not examined by the National Office.

A similar result was reached in Field Service Advice199940012. There, the taxpayer was a German manufacturing company. It sent personnel to customer installation sites for extended periods of time to receive the equipment and complete the installation and testing. Employees were sent to the U.S. At some point, the German company was advised that it had a permanent establishment in the U.S. and that U.S. tax returns should be filed. The Taxpayer came forward to the I.R.S. voluntarily, and committed to file and pay the proper amount of tax due for the years in issue, regardless of the I.R.S. position as to the deductibility of expenses. More than 18 months have passed since the due dates for the returns for the years in question.

The taxpayer requested a waiver of the timely-filing requirement. The office of the Associate Chief Counsel (International) refused the to grant the waiver for reasons similar to those discussed in the Technical Advice Memorandum discussed above. The regulations and case law apply a "terminal date" for the filing of tax returns. If a return is filed after that date, no deductions are allowed. This is a valid administrative provision designed to encourage compliance. It existed at the time the Germany-U.S. Income Tax Treaty came into force and effect. Moreover, because the provision is administrative in nature, it does not purport to affect how expenses are allocated between a German company and its permanent establishment in the U.S. Consequently, it is not inconsistent with the treaty.

A similar conclusion was reached in Field Service Advice 199944026. There, a U.K. corporation with a place of business in the U.S. was acquired by a U.S. corporation. The U.K. corporation consistently filed its tax returns late. This was blamed on problems encountered in the acquisition. Unfortunately, the result was the same as in the prior documents discussed above. The U.K. corporation was denied the benefit of deductions in computing taxable income.

c. Alternative Minimum Tax may be imposed on U.S. citizen residing in Germany or England notwithstanding any provision in the relevant income tax treaties.

In Pekar v. Commr., 113 T.C. ___No. 12 (September 1, 1999), the U.S. Tax Court was asked to address the interplay between the AMT and U.S. foreign tax credit obligations under several income tax treaties. The case involved Mr. Pekar, a U.S. citizen, who resided in Germany and the U.K. during his 1995 tax year. He paid resident income tax to the foreign countries in an amount exceeding his reported U.S. income tax liability. The taxpayer claimed a foreign tax credit that reduced his U.S. income tax to zero. However, he did not compute or report liability for the AMT. He claimed that the AMT the foreign tax credit limitations violated the relief from double taxation provisions under each of the treaties because not all of the AMT can be eliminated by foreign tax credits. Only 90% of the AMT can be offset.

The Court concluded that nothing in the treaties prevented the U.S. from imposing the AMT. Further, the limitation of the AMT foreign tax credit to 90% of the AMT is a foreign tax credit limitation allowed under each of the treaties. It is expressly recognized in the Germany-U.S. Income Tax Treaty. To the extent it not a limitation and is not recognized as such in the U.K.-U.S. Income Tax Treaty, a conflict exists between the treaty and the terms of U.S. domestic tax law. The conflict should be resolved in favor of the domestic law under the last-in-time doctrine. The AMT provision was enacted after the treaty with the U.K. came into force.

d. Application of Netherlands-U.S. Income Tax Treaty ignored in context of Canada-U.S. financing.

In Del Commercial Properties Inc. v. Commr., T.C. Memo. 1999-411, the U.S. Tax Court refused to apply the interest article of the Netherlands-U.S. Income Tax Treaty. Hence, interest channeled to the Netherlands and ultimately to Canada was subject to U.S. withholding tax at the rate of 10%, as provided in the Canada-U.S. Income Tax Treaty.

The case involves a typical cross border arrangement designed to obtain the withholding tax exemption for interest paid by a U.S. borrower to a related finance company resident in the Netherlands. The Court concluded either that the insertion of a Dutch intermediary finance company was a sham or that it was obliged to pass the interest onto its Canadian parent company. In either event, the Court ignored the interest payment by the U.S. company to the Dutch finance company and treated the transaction as if it were a direct payment of interest to the Canadian parent company. Aiken Indus., Inc. v. Commr., 56 T.C. 925, 934 (1971), was followed. Northern Ind. Pub. Serv. Co. v. Commr., 105 T.C. 341 (1995), affd. 115 F.3d 506 (7th Cir. 1997), was distinguished because it involved a U.S. corporation that obtained financing from unrelated parties on the Eurobond market and because the finance affiliate reported a spread between interest income and interest expense.

2. Foreign Trusts.

a. Final and temporary regulations issued with regard to foreign trusts and trusts that have foreign persons as grantors.

U.S. tax law contains provisions designed to prevent U.S. beneficiaries of foreign trusts from avoiding tax liability in connection with the receipt of trust distributions. Among other things, the provisions state that, with certain exceptions for revocable trusts, employee trusts, and trust providing for distributions exclusively to the grantor during life, a trust cannot be considered to be a grantor trust in the absence of a grantor that is taxable in the U.S. on the income of the trust. Other provisions are designed to ensure that sufficient information is provided to enable a U.S. beneficiary to comply with his reporting obligations. Finally, payments to U.S. persons may be treated as trust distributions to the extent routed through third parties.

Final regulations have been issued with regard to several of the provisions. Regarding intermediaries, the final regulations provide that the intermediary will be disregarded and the amount will be deemed to have been paid directly by the foreign trust to the U.S. beneficiary if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax. A transfer of property will be deemed to have been made pursuant to that type of plan if the following factors are present:

i. The U.S. person is related to a grantor of the foreign trust or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the U.S. person.

ii. The U.S. person receives from the intermediary, within a 48-month period surrounding the intermediary's receipt of property, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and

iii. The U.S. person cannot demonstrate to the satisfaction of the I.R.S. that –

    (1) The intermediary has a relationship with the U.S. person that justifies a gratuitous transfer to the U.S. person,

    (2) The intermediary acted independently of the grantor and the trustee,

    (3) The intermediary is not an agent of the U.S. person under generally applicable U.S. agency principles, and

    (4) The U.S. person timely complied with the reporting requirement of section 6039F, if applicable, if the intermediary is a foreign person.

Nonetheless, the preamble to the final regulations cautions that the presumption goes only so far. The I.R.S. may find that a transfer was made pursuant to a tax avoidance plan even if none of the specified factors are present.

Under the final regulations, property is treated as transferred to the U.S. person in the year it is actually transferred to the U.S. person by the intermediary unless the I.R.S. determines, or the taxpayer can demonstrate to the satisfaction of the I.R.S., that the intermediary is an agent of the U.S. person under generally applicable agency principles, in which case the property will be treated as transferred to the U.S. person by the trust in the year the property was transferred to the intermediary by the trust. As a corollary, the final regulations provide that the fair market value of the property is determined as of the date of the transfer to the U.S. person, unless the intermediary is treated as an agent of the U.S. person, in which case the fair market value will be determined as of the date of the transfer to the intermediary.

Temporary regulations have been issued with regard to other provisions of the law. Under the original proposed regulations, a grantor was defined to include any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. This included a nominal creator who made no transfer to a trust. The temporary regulations continue this rule for reporting purposes. Treating a nominal creator as a grantor ensures that someone will be responsible for reporting the creation of a foreign trust by a U.S. person even if the trust is not immediately funded. At the same time, the temporary regulations reflect the view that it is unfair to treat an accommodation grantor, such as an attorney who creates a trust on behalf of a client, as an owner of the trust. Accordingly, the temporary regulations provide that a person who either creates a trust, or funds a trust with an amount that is directly repaid to such person within a reasonable period of time, but who makes no other transfers to the trust that constitute gratuitous transfers, will not be treated as an owner of any portion of the trust under the grantor trust rules.

The temporary regulations address a distribution from one trust to another trust that is a beneficiary of the first trust. The distribution can be categorized as a gratuitous transfer, with the result that the first trust would be a grantor of the second trust. The temporary regulations move away from this result. Instead, the grantor of the transferor trust will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of the beneficiary trust, such person will be treated as the grantor of the transferee trust.

The temporary regulations include a new section that applies to gratuitous transfers to trusts by partnerships and corporations. If the transfer is entered into for a business purpose of the partnership or corporation, the partnership or corporation, as the case may be, generally is treated as the grantor of the trust. However, if the transfer is not entered into for a business purpose of the partnership or corporation – for example, if it is for the personal purposes of one or more of the partners or shareholders -- the transfer is treated as a constructive distribution to such partners or shareholders under federal tax principles, and the partners or shareholders, as the case may be, are treated as the grantors of the trust.

Final regulations have been adopted which address the way a trust determines whether it has a foreign grantor. Instead of a two-step procedure that was the proposed regulations, the final regulations provide that the general grantor trust rules apply to determine whether any portion of the trust would have a person, other than a U.S. person, as the grantor. If so, the trust will be treated as a grantor trust only in limited circumstances. A complex set of rules applies if the grantor is a C.F.C., Foreign Personal Holding Corporation, or a Passive Foreign Investment Company.

U.S. law provides an exception to the rule that a trust cannot be a grantor trust if a foreign person would be treated as the grantor. If the trust is revocable without the consent of an adverse party so that the property revests in the grantor, the general rule is inapplicable. Proposed regulations provided that the right to have the property revest in the grantor had to exist for 183 days. The final regulations waive the 183-day requirement in the first year or the final year of the trust. If the grantor becomes incapacitated, the exception will continue to apply if there is a guardian or other person who has unrestricted authority to exercise the necessary power on the grantor's behalf. The final regulations clarify that, consistent with the principle that statutory exceptions should be construed narrowly, if a trust fails to qualify for the revocable trust exception in a particular year, the exception cannot apply in a later year even if the requirements would otherwise be satisfied in such later year.

Under the proposed regulations, gifts from foreign corporations or foreign partnerships were treated as dividends or income unless a U.S. person could be identified a shareholder or partners and that U.S. person took the gift into account for U.S. tax purposes and made a gift to the U.S. donee. The final regulations provide an additional exception where the U.S. donee can establish that a foreign individual treated and reported the purported gift for purposes of the tax laws of the country in which the foreign person is resident as a distribution from the partnership or foreign corporation and a subsequent gift to the donee, and provided further, that the U.S. donee timely complied with the filing requirements. The final regulations provide a second additional exception for purported gifts from domestic partnerships that are beneficially owned exclusively by U.S. citizens or residents or domestic corporations.

If the transferring partnership or foreign corporation receives some consideration from the U.S. donee, but the consideration is less than the fair market value of the property transferred, only the excess will be treated as a purported gift. Further, no portion will be treated as a purported gift under the final regulations if the U.S. donee neither is related to a partner or shareholder of the transferor nor has another relationship with a partner or shareholder of the transferor so that there is a reasonable basis for concluding that the partner or shareholder would make a gratuitous transfer to the U.S. donee.

3. <u>Transfer Pricing</u>.

a. <u>Placement of the right to receive income in a company resident in a tax-favored jurisdiction is not sufficient to support income stream to that company</u>.

In <u>United Parcel Service of America, Inc. v. Commr.</u>, T.C. Memo 1999-268, the U.S. Tax Court refused to recognize the bona fides of an income stream in which revenue produced in the U.S. was channeled to an offshore affiliate. As a result, the taxpayer was not entitled to deduct payments made to the offshore affiliate for amounts collected in the U.S.

The case involved U.P.S., a large shipper of parcels in the U.S. The taxpayer charged its customers a fee for the shipment of each package based on the weight of the package, the distance that the package would travel, the value of the package, and various accessorial services offered by petitioner.

Regarding claims for goods damaged in transit, the taxpayer was obligated to customers to pay up to the actual or declared value for loss or damages caused by petitioner during the course of transporting the package, subject to a ceiling of $100 per package. U.P.S. offered customers the opportunity to purchase additional loss coverage at rates of $0.25 for each $100 of additional coverage. For 1983, U.P.S. collected the premiums for excess coverage and self-insured the risk. It bore the credit risk of customer payment for premiums and was responsible for receiving the claim, confirming the loss, and making payment.

For 1984, the excess coverage obligation was passed on to an affiliated, captive insurance company in Bermuda. The taxpayer continued to bear the credit risk and remained responsible for collecting coverage premiums, processing claims, and making payments. Although the taxpayer continued to collect premiums, it did so as agent of the Bermuda insurance company; hence, no portion of the excess coverage premium was included in the taxpayer's income. The taxpayer did not receive reimbursement or compensation for carrying on these duties. The taxpayer was not a licensed insurance broker or claims adjuster in the U.S.

For 1984, U.P.S. collected almost $100 million of premiums for excess coverage, paid out over $22 million in claims, and paid almost $78 million to the Bermuda affiliate. During the same year, a competing insurance company offered comparable insurance to shippers at rates of between $0.125 and $0.175 per $100, depending on loss experience in the industry.

Upon review by the I.R.S., several adjustments were made to income. The $100 million was added to income, no deduction was allowed for any reinsurance premiums to the affiliate, and a negligence penalty was added to the adjustment to tax. These adjustments were upheld by the U.S. Tax Court.

The Court applied certain fundamental principles of tax law that often are ignored in sophisticated tax planning arrangements. These may be summarized as follows:

i. Gross income means all income from whatever source derived.

ii. Income must be taxed to the party that earns it.

iii. The incidents of taxation cannot be avoided through an anticipatory assignment of income.

iv. The question of who should be taxed depends on which person or entity in fact controls the earning of the income rather than who ultimately receives the income.

v. A taxpayer realizes income if he controls the disposition of that which he could have received himself but diverts to another as a means of procuring the satisfaction of his goals.

vi. The receipt of income by the other party under such circumstances is merely the fruition of the taxpayer's economic gain.

The same activities that were performed by the taxpayer in 1983 continued to be performed in 1984. The mere signing of a reinsurance contract with no change in risks, functions, or responsibilities could not cause $77 million to be removed from a U.S. tax return and into a tax-free environment in the hands of an affiliate. According to the Court, there was no economic substance to distinguish the 1983 procedures from those followed in 1984. Had the activities, risks, or responsibilities of U.P.S. been reduced in 1984, perhaps the affiliate would have been entitled to revenue. However, the absence of any economic change precluded the taxpayer from diverting income. In essence, the arrangement was a sham.

The Court dismissed the argument of the taxpayer that it had legitimate business purposes for entering into the arrangement, other than tax avoidance. According to the taxpayer, a serious concern existed that the continued receipt of the excess coverage premiums was potentially illegal under various State insurance laws. It was this concern that motivated it to rearrange its method of operations. Unfortunately, the taxpayer was not able to produce any documentation substantiating the existence of the concern other than the report of an informal conversation between a company executive and an insurance broker. There were no studies, no reports, and no advice from legal counsel or experts. The Court viewed as incredulous the argument that $100 million of annual revenue would be voluntarily relinquished on the basis of an informal discussion of a corporate executive.

Once the Court reached its conclusion as to substantive tax law, it affirmed negligence penalties (5%), substantial understatement of income penalties (25%), and penalty interest for tax motivated transactions (20% increase in rate). The factual basis for the taxpayer's position was so nebulous that none of the good faith, substantial authority, or full disclosure exceptions were held to apply.

b. <u>Rev. Proc. 65-17 relief allowing for cash-flow offsets when a transfer pricing adjustment is made is up is updated</u>.

In Rev. Proc. 99-32, 1999-34 I.R.B. 296, the I.R.S. set forth its position regarding adjustments that may be made to conform the accounts of taxpayers to reflect allocations made under Code §482.

In Announcement 99-1, 1999-2 I.R.B. 11, the Internal Revenue Service invited comment on a revision of Rev. Proc. 65-17, 1965-1 C.B. 833, which was the basic provision of the I.R.S. under which cash flows could be conformed to income adjustments proposed under Code §482. The adjustment may be made by the I.R.S. or it can be made by a taxpayer increasing or decreasing its income over that which reflects the actual transaction. Taxpayer-initiated transactions are contemplated in Regs. §1.482-1(a)(3).

The basic problem addressed by Rev. Proc. 65-17 involves the differences between flows of funds and the computation of income adjusted by the I.R.S. From an inbound perspective, the cash generated to a foreign supplier is greater than it would have been had a transaction been carried out at arm's length. The reason is that the payment to the foreign supplier is more than an arm's length amount. When the transaction is adjusted, the excess cash in the hands of the supplier must be justified. The I.R.S. position is that, unless relief is requested, the excess cash payment should be treated as a divided. Rev. Proc 65-17 allows relief by treating the excess as an interest-bearing account receivable that can be repaid to the U.S. taxpayer. This prevents the imposition of dividend withholding tax in addition to the basic transfer pricing adjustment.

For an outbound transaction, Rev. Proc. 65-17 allows a taxpayer to recharacterize dividends received from foreign subsidiaries to the extent the dividends do not exceed an increase in the U.S. taxpayer's income attributable to a transfer pricing adjustment.

Under Rev. Proc. 99-32, the accounts of a taxpayer may be adjusted following a transfer pricing adjustment if certain conditions are met. First, no penalty must be proposed under Code §6662(e)(1)(B) or (h) with regard to the transfer pricing adjustment. The former section provides for a 20% penalty imposed on the tax increase; the latter section provides for a 40% penalty in the event of a gross understatement of income. Second, no portion of the adjustment must be due to fraud. Finally, the taxpayer must agree to be bound by the provision in order to obtain relief. In other words, the Rev. Proc. should not be the starting point of negotiations.

Under Rev. Proc. 99-32, a U.S. taxpayer is permitted to establish an interest-bearing account receivable from the related person -- it must be a corporation, not a partnership – with whom a non-arm's length transaction was entered into. The account receivable is deemed to arise on the last day of the taxable year involved in the adjustment. It must be paid within 90 days and can be deemed to be prepaid in certain circumstances. For an outbound taxpayer, the receipt of dividends from the other party to the transaction may be treated as a prepayment. Once a dividend is recharacterized, it is no longer treated as a dividend for U.S. income tax purposes. For both inbound and outbound taxpayer, prepayment can arise from an accounting entry offsetting a bona fide debt between the U.S. taxpayer (or member of its affiliated group) and the related person. For inbound taxpayer, prepayment can arise from a contribution to capital.

Time limits are placed on the ability to use a transaction as a prepayment. The offsetting transaction must occur during the taxable year of the transfer pricing adjustment, the taxable year in which a taxpayer-initiated adjustment is reported, or the taxable year in which a closing agreement is entered. No untimely or amended returns will be permitted to claim offset treatment by reason of such a bona fide debt, distribution, or capital contribution during the taxable year.

The Rev. Proc is effective for taxable years beginning after August 23, 1999. A taxpayer may elect to apply all of the provisions of the Rev. Proc. to its U.S. income tax return for its taxable year that includes August 23, 1999. Finally, if a taxpayer initiates an adjustment for a taxable year prior to August 23, 1999, it will be permitted to apply the principles of Rev. Proc. 65-17 in accordance with any reasonable interpretation thereof for purposes of conforming accounts to reflect the taxpayer-initiated primary adjustment.

c. <u>Advance payments for inventory are trade receivables for which no interest need be charged for a limited, interest-free period</u>.

The income tax regulations relating to the arm's length transfer pricing standard of Code §482 contain provisions which mandate the payment of interest when one company that is a member of a controlled group lends money to another member. A limited exception to this rule applies to trade receivables. No interest need be charged for trade receivables that are repaid within a specified period. Ordinarily that period runs from the date the trade receivables arise to the first day of the third calendar month thereafter. If the trade receivable results from a foreign sale, the interest-free period runs to the first day of the fourth month. In either event, the period can be lengthened if a longer period is customary in the industry.

In Private Letter Ruling 199949027, the office of Associate Chief Counsel (International) addressed the treatment of advance payments from the customer to the supplier. In essence, these are the obverse of typical trade receivables because the customer makes payment before delivery rather than after billing. The taxpayer prepaid offshore affiliates that supplied it with inventory, because the invoice was denominated in foreign currency and the taxpayer wished to shield against currency risk. Provided it could reasonably be assumed that the inventory would be delivered within 3½ months, the taxpayer was deemed to receive the property at the time of payment under the economic performance rules of Code §46. Relying on Rev. Rul. 82-135, 1982-2 C.B. 104, the I.R.S. ruled that no interest need accrue on any of the advance payments until the first day of the fourth month following the advance.

d. Effect of antidumping duties on the computation of an arm's length price explained. Taxable income is not reduced by the antidumping duties.

In Field Service Advice 199945011, the office of Associate Chief Counsel (International) explained the effect of antidumping duties on the computation of an arm's length price under the comparable profits method of the regulations.

A U.S. subsidiary of a foreign-based group of companies imported and distributed a product manufactured abroad. A competitor filed an antidumping petition alleging that the U.S. subsidiary sold the product at less than fair value, and that those sales caused, or threatened to cause, material injury to the domestic industry producing a "like product." The Commerce Department issued an antidumping duty order and the U.S. subsidiary was required to post cash deposits with the Customs Service equal to a specified percentage of the entered customs value of the merchandise. The deposit approximated the margin by which the product was sold at less than fair value.

The obligation to pay antidumping duties is imposed on the importer. If the importer is reimbursed by the foreign manufacturer, the duties are increased to absorb the reimbursement.

Initially, the U.S. subsidiary included cash deposits of antidumping duties in cost of goods sold, and deducted such deposits as it consumed inventory. At some point, it filed Form 3115 (Application for Change in Accounting Method), in which it requested I.R.S. permission to change from including antidumping duty cash deposits as a component of cost of goods sold to deducting them only when (and if) antidumping duty liability was finally imposed, upon liquidation of import entries.

On a timely-filed tax return , the U.S. subsidiary made an adjustment in its income pursuant to Regs. §1.482-1(a)(3) and the comparable profits method which reduced income. A large portion of the adjustment was attributed to cumulative antidumping duty deposits. The adjustment reflected the view that the deposits were properly eliminated from operating profit as "extraordinary items." The U.S. subsidiary reduced its income by an additional amount, in order to place its three-year average operating profit -- stated on a basis that excluded the effect of antidumping duty deposits -- within the interquartile range of operating profits of the comparables.

The advice concluded that, in applying the comparable profits method, the potential for antidumping duties and the associated obligation to post deposits likely constitute significant risks that would materially affect the prices charged, or the profit earned, in connection with the importation of the merchandise. It would likely have been taken into account by parties dealing at arm's length. This risk, condition, or circumstance existed with respect to the business activity of the U.S. subsidiary involving related party transactions, but not with respect to comparables uncontrolled transactions. Accordingly, adjustments were required to account for the ascertainable effect of such differences on prices or profits to improve the reliability of the results.

Although this seems odd in the context of an antidumping allegation, the effect of the adjustment was that the intercompany price were reduced to allocate more profit to the U.S. subsidiary. This was justified under the view that the arm's length pricing and antidumping policies are mutually reinforcing. By adjusting the application of the comparable profits method to reflect the differences between the U.S. subsidiary and the comparables with reference to the potential for antidumping duties, the U.S. subsidiary was required to report the same operating profit whether or not dumping occurs. This treatment avoided any tax advantage as a result of the dumping. Moreover, it prevented shift in the burden of final duties to the foreign exporter. That would contravene the Commerce regulations, which dictate that such risk rests with the U.S. importer.

4. <u>Reorganizations</u>

a. <u>Regulations issued for spin-offs of U.S. corporations to foreign shareholders and to liquidations of U.S. corporation in the context of an 80% or greater foreign corporate shareholder</u>.

Code §367(e)(1) provides rules for the spin-off of a U.S. corporation to foreign persons holding shares of the distributing corporation. In broad terms, it authorizes the I.R.S. to provide regulations under which the U.S. corporation making the distribution must recognize gain on that distribution. Temporary regulations were issued in 1990 and 1996. Final regulations were published in 1999.

The final regulations generally implement the temporary regulations, subject to certain modifications. One such modification is that a distribution of a U.S. corporation to foreign shareholders will no longer cause the distributing corporation to recognize gain. According to the preamble to the regulations, the I.R.S. weighed the administrative burdens to taxpayers and the Government in connection with rules requiring gain recognition agreements and similar arrangements. It concluded that adequate protections are in place to protect the policies of Code §367(e)(1). The preamble specifically points to Code §355(d) and (e) and the device and continuity of interest requirements of Code §355.

Code §367(e)(2) provides rules for the liquidation of a corporation in the context of an 80% or greater foreign corporate parent. Ordinarily, a U.S. corporation is not required to recognize gain on the distribution of assets in liquidation to the extent attributable to the interests of an 80% or greater corporate shareholder. This rule does not apply when the corporate shareholder is a foreign corporation, except to the extent provided in regulations. As with the spin-off regulations, final regulations were published in 1999.

The final regulations retain the exceptions in the proposed regulations for a distribution of assets used in the conduct of a U.S. trade or business -- the recipient must use the assets for 10 years in a U.S. trade or business -- and for a distribution of a U.S. real property interest -- the rules under F.I.R.P.T.A. control. In addition, the final regulations provide a new exception for a distribution of stock of a domestic subsidiary that is 80% owned by vote and value directly by the liquidating corporation. The final regulations limit the recognition of built-in gains and losses attributable to property received by the domestic liquidating corporation in a reorganization or liquidation occurring within two years prior to the distribution. The losses attributable to those assets will not offset the liquidation gains. In addition, the regulations recognize that anti-stuffing rules of Code §§336(d) and 382 apply to limit loss recognition in applicable circumstances.

The final regulations contain a new anti-abuse rule that allows the Commissioner to require the liquidating corporation to recognize gain (or treat the liquidating corporation as if it had recognized loss) on the distribution of property pursuant to the liquidation if a principal purpose of the liquidation is the avoidance of U.S. tax. The rule would apply, for example, if a principal purpose of a liquidation is the distribution of a domestic liquidating corporation's earnings and profits without a U.S. withholding tax. In certain circumstances, the Service is also concerned about a liquidation of a domestic corporation into a U.S. branch of a foreign corporation in a manner that facilitates the avoidance of U.S. tax, including the inappropriate use of attributes such as net operating losses.

b. F.I.R.P.T.A. exception for certain reorganizations expanded.

Gains of foreign persons from the disposition of a U.S. Real Property Interest are taxable under Code §897. An exception is provided when the exchange is part of a tax-free reorganization and the property received will be taxable under F.I.R.P.T.A. upon its disposition. Notice 99-43 advises that final regulations will expand the exception to cover recapitalization or reincorporation of a single corporation that is categorized as a U.S. Real Property Holding Corporation because more than 50% of the value of its assets consisted of U.S. Real Property Interests at some point within the preceding 5 years but at the time of the recapitalization those interests amounted to less than 50% of total value.

c. I.R.S. allows for tax-free treatment of merger involving foreign parent company shares even though principles of regulations will not be clearly met.

In order for U.S. shareholders of a U.S. corporation to have tax-free treatment when the shares of the U.S. corporation are acquired by a foreign corporation, a series of tests set forth in the regulations issued under Code §367(a) must be met. These tests appear in Regs. §1.367(a)-3(c), and may be summarized as follows:

i. The amount of stock received by the U.S. transferors must not exceed the 50% of both the total voting power and the total value of the stock of the acquirer;

ii. Not more than 50% of the total voting power and the total value of the stock of the acquirer can be owned, in the aggregate, immediately after the transfer by U.S. persons that are officers, directors, or 5% shareholders of the U.S. target company;

iii. The U.S. transferor must not be a 5%shareholder, or if he is, he has entered into a 5-year gain recognition agreement with the I.R.S., under which he agrees to recognize gain retroactively in the event the target company is sold within 5 years by the acquirer;

iv. The acquiring company must be considered to be engaged in an active trade or business for 36 months; and

v. The acquiring company must be substantial in relation to the U.S. target, with a value at least equal to that of the target.

In Private Letter Ruling 199929039, the I.R.S. ruled that a statutory merger by which a U.S. public company was acquired in return for shares of a foreign parent company would qualify as a tax-free reorganization under Code §368(a)(1)(A) even though the fair market value of the acquirer could be less than that of the target on the closing date. In a statutory merger, the acquiring company can use shares of stock of its parent as consideration for the acquisition. See Code §368(a)(2)(E).

The foreign corporation agreed to pay a significant premium for the shares of the target. As a result of the premium, it was not clear that the foreign corporation's market value would be equal to or greater than the U.S. corporation market value on the date of closing. Prior to announcing the transaction, the market value of the acquiring European company was greater than that of the target. The regulations permit the I.R.S. to issue a letter ruling that substantial compliance with the regulatory standards exists in the event the active trade or business test or the substantial value test is not met. Here, the target and the acquirer were major publicly traded companies and the I.R.S. determined that substantial compliance existed.

d. Loan stock received by U.S. subsidiary of foreign group is treated as equity.

In FSA 199929002, a U.S. company was the direct subsidiary of a foreign parent company. The U.S. subsidiary transferred certain assets to a lower-tier company resident in the same jurisdiction as its parent. In return, the U.S. company received shares of loan stock.

The loan stock contained the following terms. The rights of the holders were subordinated to the rights of all other creditors in the event of liquidation. The final redemption date was identified and was long term, although not 50 years. The interest or "coupon" rate was fixed and was made in two payments on June 30, and December 31, each year until the redemption date. The loan stock was not convertible to any other security and was made redeemable at par plus any accrued interest. In the event of liquidation of the issuer, the loan stock and arrears coupon payments were converted into preference shares. The preference shares did not have rights to share in the profits of the issuer except for the coupon and the liquidation amounts. The preference shares did not have the right to vote at general meetings, except by resolution to allow them to vote or in the event the preference shares were proposed to be canceled.

The issue was couched in the status of an instrument as debt or equity. The loan stock was treated as debt in the jurisdiction of the issuer and coupon payments are considered to be deductible interest. If equity, the instrument were held to be equity, the transaction would qualify as a tax-free transfer to a corporation in return for the issuance of stock for which gain is not recognized by reason of Code §351. Whether an instrument is equity or a debt is a question of fact to be decided on a case by case basis. Courts have traditionally utilized a number of factors in determining whether an instrument is debt or equity. Here, the office of Associate Chief Counsel (International) concluded that the instrument was properly treated as equity.

The loan stock had some of the formal indicia of debt and equity. The name of the instrument was itself inherently ambiguous. Debt characterization was supported by the provision for the repayment of a sum certain and a specified coupon rate is indicative of debt. On the other hand, equity characterization was indicated by the absence of traditional creditor remedies for failure to make the required coupon payments, subordination of the rights of the loan stock holders to all other creditors, and a high debt-to-equity ratio. In total the instrument was viewed to be equity, notwithstanding the treatment by the issue in its jurisdiction of residence.

e. <u>I.R.S. allows a U.S. corporation to be converted into a foreign corporation as part of a tax-free reorganization</u>.

In Private Letter Ruling 199931029, the I.R.S. ruled that a U.S. corporation's conversion to a foreign corporation will be treated as a tax-free reorganization under Code §368(a)(1)(F). The underlying transaction likely reflected changes made to Code §367(a) which eliminates toll charges in connection with the transfer of assets to a foreign entity treated as a partnership for U.S. income tax purposes.

In the ruling, a U.S. parent company owned a U.S. subsidiary that was a member of a foreign joint venture engaged in mining operations. Each joint venture member owned its pro rata interest in the assets of the mine, paid its pro rata share of production costs, and was entitled to take its share of the minerals. For valid reasons, the U.S. subsidiary undertook to move its corporate charter from the U.S. to the country in which the mining activities were located. The emigration of the corporate charter was accompanied by the formation of an eligible entity in the same foreign country which elected to be treated as a disregarded entity for U.S. income tax purposes. The U.S. parent transferred the subsidiary's shares to the disregarded entity. A dividend, paid in the form of a note, was paid to the disregarded entity. Ultimately, the note was repaid by the subsidiary. Presumably, the dividend transaction reduced any potential capital tax that would otherwise be due at the time the subsidiary's corporate charter was transferred to the foreign jurisdiction.

The I.R.S. ruled that the transaction was an F-reorganization, *viz.*, a mere change in the place of organization of an entity, provided that the dividend amounted to less than 50% of the fair market value of the subsidiary.

f. Transfer of foreign currency denominated note to U.S. subsidiary is part of a Code §351 transaction and carryover basis exists.

In Field Service Advice FSA 199935019, the office of Associate Chief Counsel (International) concluded that the basis maintained in a foreign currency denominated note was greater in the hands of a U.S. corporation than the basis maintained by the original creditor.

The issue arose in the context of a foreign controlled group having affiliates in the U.S. A foreign member of the foreign controlled group loaned funds to a second tier U.S. subsidiary. In return, the U.S. subsidiary issued a note denominated in foreign currency. While the note was outstanding, the value of the foreign currency appreciated against the U.S. Dollar. At some point, the foreign parent company acquired the note from the original creditor. Although the purchase price was at par in terms of foreign currency units, the U.S. Dollar equivalent of the purchase price exceeded the U.S. Dollar equivalent of the amount originally borrowed. Within days, the note was contributed to a U.S. first tier holding company in return for the issuance of shares. Thereafter, the U.S. holding company contributed the note to a different U.S. company it owned in return for the issuance of shares. Ultimately, the note was paid off. At the time the note was paid off, the value of the foreign currency depreciated below that in effect at the time of issuance of the note. The issuer recognized a relatively small currency gain. The holder recognized a substantial currency loss. Its basis in the note was controlled by the U.S. Dollar value of the purchase price paid by the foreign parent.

The examiner attempted to deny the currency loss in excess of the currency gain. He asserted that the transaction by which the basis in the currency units was increased for U.S. tax purposes was a sham. However, the office of Associate Chief Counsel (International) concluded that the facts did not warrant the assertion. Each separate transaction had significant economic consequences. The economic effect of the transactions was to allow the original foreign holder of the note to receive cash in exchange for the note. The facts presented do not indicate that the sole purpose of the transfer was to achieve tax consequences on the disposition of the property by the transferee that were more favorable than the tax consequences of a disposition by the transferor.

Any recharacterization under the substance over form doctrine would leave the parties in the same ultimate economic positions. The original holder of the note cannot be deemed to have distributed the note to its foreign parent as a dividend because this recharacterization does not account for the cash that the original holder received in exchange for the note. In addition, the original holder cannot be deemed to have contributed the note to the U.S. holding company in a tax-free contribution to capital because the former company is not a shareholder in the latter. Moreover, that recharacterization does not account for the cash which the original holder received from its parent. Even if the cash were deemed contributed to the holding company which acquired the note from the original holder, the tax result in the U.S. would be unchanged.

g. Merger of dual resident corporation triggers recapture of dual consolidated losses.

Field Service Advice 199949030, involves a U.S. group of corporation that files a consolidated tax return. One of the members of the group is a dual resident corporation that manufactures a product outside the U.S. That subsidiary had losses which were used in the U.S. group's consolidated tax return. The group was acquired by merger of the parent into another company. This was an event that triggered recapture of the dual consolidated loss of the subsidiary. Recapture of the dual consolidated loss can be avoided if the former parent and the acquiring company enter into a closing agreement calling for the filing of certifications that the losses are not used by related companies abroad other than the dual resident corporation. The taxpayer attempted to enter into a closing agreement but the office of Associate Chief Counsel (International) recommended that the I.R.S. not enter the agreement because certifications for prior years were not acceptable. A closing agreement could be entered once the taxpayer cured the deficiency for earlier years.FSA 199949030

5. Miscellaneous Corporate Transactions.

a. Deferred loss transaction arising from cross border sale of assets is not triggered when loss company leaves group.

In Unionbancal Corporation v. Commr., 113 T.C. ___ No. 22 (October 22, 1999), the Tax Court refused to allow a deferred loss in 1984 to be triggered by a company's departure from a cross-border group.

In 1984, the taxpayer belonged to a controlled group of corporations that included its indirect U.K. parent corporation. In 1984, the taxpayer sold a loan portfolio to its indirect U.K. parent corporation, realizing a loss of $87.9 million. The I.R.S. determined that a deduction of $2.3 million was allowable for 1984, but that the balance of the loss had to be deferred pursuant to Code §267(f). In 1988, the taxpayer left the controlled group, which still held the loan portfolio. The I.R.S. denied a deduction for taxable year 1988 for the remaining amount of the loss associated with the sale of the loan portfolio (i.e., $85.6 million).

For U.K. income tax purposes, the indirect parent company claimed losses with respect to the loan portfolio predicated on the loan portfolio's having a U.K. tax basis of $422,985,520. However, Inland Revenue determined that the tax basis was overstated. Consequently, the allowable losses were reduced for U.K. income tax purposes.

Competent authority assistance was requested to resolve the value of the loan portfolio and related issues. The competent authorities agreed that the value of the loan portfolio was $346,630,214 and that petitioner's loss on the sale was $87,927,200. The competent authorities were unable, however, to resolve the tax treatment of this loss. The U.S. would not withdraw its adjustment disallowing the loss to the taxpayer. The U.K. would not allow the indirect parent company to increase its basis in the loan portfolio to reflect the loss disallowed petitioner for U.S. income tax purposes. The taxpayer never returned the excess amount to its indirect parent company.

When the taxpayer left the group, it claimed the balance of the deferred loss as a deduction. The deduction was disallowed by reason of Code §267(f)(2). Code §267 provides denial or deferral for losses arising from transactions among related parties. In particular, Code §267(f)(2) provides that any loss from the sale or exchange of property between members of the same controlled group deferred until the property is transferred outside the controlled group and there would be recognition of loss under consolidated return principles or until such other time as prescribed in regulations.
At the time, temporary consolidated return regulations provided that a departing member of a group would never be entitled to a loss if, at the time of departure from the group, the property continued to be held by a member of the group. Instead of a loss, the member holding the property was entitled to an increase in basis. This had the effect of retaining the loss within the controlled group. In 1995, final regulations were published allowing the loss to be recognized by the departing member of the group. The final regulations are applied prospectively.

The taxpayer argued that the temporary regulations were invalid, and that in its circumstances, the temporary regulations violated the U.K.-U.S. Income Tax Treaty because the effect is to permanently deny a deduction for the loss of a U.S. corporation that is owned by a U.K. corporation when property is sold to the U.K. corporation. The Court disagreed. After finding the temporary regulations valid as a matter of domestic law, the Court reasoned that the permanent disallowance had nothing to do with the method of triggering gain under the loss deferral rules. According to the Court, the problem was that the U.K. would not allow a step-up in basis as provided by U.S. tax law. This had nothing to do with the regulation. The taxpayer should have sold the property to a U.S. affiliate or an affiliate in a country other than the U.K.. The validity of the Temporary Regulation cannot depend upon the treatment of the deferred loss under foreign tax law

b. Refinancing of foreign debt instruments results in foreign exchange losses.

In Field Service Advice 199928007, the I.R.S. was presented with a U.S. company owned by five foreign corporations. The functional currency of the U.S. company was the U.S. Dollar. The U.S. company was capitalized with debt, denominated in foreign currency. The only asset of the U.S. company consisted of shares a foreign company located in the jurisdiction in whose currency the loans were denominated. When the loans matured, the U.S. company used the proceeds of new loans to meet its obligation. The company deducted the currency loss and the deduction was challenged in examination.

In advice to the examiner, the office of Associate Chief Counsel (International) concluded that the refinancing generated a recognizable currency loss. The economic effect of paying the old loans with proceeds from the new loans having identical terms and conditions was to extend the maturity date of the original loans. Thus, the issue is whether this was a material modification that would give rise to a realization event. Under Regs. §1.1001-3, (e)(3) a modification that changes the timing of payments due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. Deferral is material if it lasts longer than the lesser of five years or 50% of the original term of the instrument. Here, both the original and replacement loans were for 5 years, and accordingly, deferral was material.

c. I.R.S. concludes that "check-the-box" election to disregard subsidiary cannot be used to avoid Subpart F Income.

In Technical Assistance Memorandum 199937038, a U.S. taxpayer's first tier foreign subsidiary contemplated the sale of a second tier subsidiary. The gain from the sale of shares would generally be considered to be an item of Foreign Personal Holding Company Income that is taxable to the U.S. shareholder under Subpart F. To avoid the result, the first tier subsidiary made a check-the-box election with regard to the second tier entity so that the latter was disregarded for U.S. income tax purposes. As a result, it treated the sale of shares as if it were a sale of the underlying trade or business assets owned by the disregarded entity. A sale of trade or business assets does not generally result in Foreign Personal Holding Company Income.

The office of Associate Chief Counsel (International) concluded that the check-the-box election did not result in a conversion of Foreign Personal Holding Company Income. The election was made only to facilitate the tax treatment in the U.S. arising from the sale. Consequently, the first-tier subsidiary never had an intent to operate a business; its intent was to sell assets. Because it never intended to operate a business, the assets sold were never used in its trade or business. The Technical Assistance Memorandum refused to attribute the business of the second-tier company to the first-tier company even though the check-the-box election is treated as a parent subsidiary liquidation with a carryover of tax attributes.

d. I.R.S. proposes regulations that would limit check-the-box elections in international context.

When the I.R.S. first issued check-the-box regulations, there was a strong feeling within the Government that extension of the regulations to international transactions provided taxpayers with too much of a good thing. Consequently, taxpayers were notified in the preamble to those regulations that the I.R.S. would monitor their application to determine whether the regulations were used in a manner that is inconsistent with the application of any provisions of U.S. domestic law. As a result of that monitoring, the I.R.S. has determined that taxpayers are using single member, disregarded

entities to achieve results in relation to certain transactions that are inconsistent with the views of the I.R.S. as to policies and rules of particular Code sections or tax treaties.
To illustrate, the I.R.S. is concerned that, by checking the box, taxpayers have: (a) changed the source of income arising from sales of shares of a disregarded entity – a sale of shares that would produce income based on residence will be converted to a sale of operating assets that will produce foreign source income for foreign tax credit purposes; (b) avoided immediate tax under Subpart F arising from sales of shares of a disregarded entity – a sale of shares that would produce Foreign Personal Holding Company Income will be converted to a sale of operating assets; and (c) avoided Code §367(a) toll charges on transfers of inventory and knowhow to a disregarded entity.

Consequently, the I.R.S. has proposed regulations intended to address the "inappropriate" use of a check-the-box election. Under the proposed regulations, a special categorization rule would apply in the event an extraordinary transaction occurs within a period commencing one day before and ending 12 months after the date that a foreign eligible entity changes its classification to that of a disregarded entity. For the special rule to apply, the entity must have been classified as an association taxable as a corporation within the 12-month period prior to the extraordinary transaction. An extraordinary event means a sale, exchange, or transfer of a10% or greater interest in the foreign entity.

The special rule is simple. The entity is not treated as a disregarded entity. Instead, it is classified as an association taxable as a corporation for all purposes of U.S. tax law. Under a limited exception, the special rule will not apply if a taxpayer establishes to the satisfaction of the I.R.S. that the classification as a disregarded entity does not materially alter the Federal tax consequence.

e. Acquisition of companies deriving foreign source business income so that the acquiring corporation can become an 80-20 corporation categorized as tax avoidance for purposes of Code §269.

Not all dividends paid by a U.S. corporation to foreign shareholders are subject to U.S. withholding tax. If a U.S. company qualifies as an 80-20 corporation, only a portion of the dividend will be subject to U.S. withholding tax. An 80-20 Corporation is a domestic U.S. corporation for which 80% or more of its gross income from all sources over a rolling three-year period is active foreign business income. Active business income may be derived directly or in form of dividends from the active business income of a subsidiary. Where a corporate group has income from domestic and foreign sources, the timing of dividend streams can enable a taxpayer to meet the standard for 80-20 characterization.

In Field Service Advice 199926011, the office of the Corporate Branch of Chief Counsel advised that the acquisition of corporations as part of a plan to cause a top-tier U.S. corporation to become an 80-20 corporation is subject to the disallowance provisions of Code §269. Under that provision, the I.R.S. may disallow a deduction, credit, or other allowance claimed by a taxpayer as a result of the acquisition of control of a corporation. Disallowance occurs if the principal purpose for making the acquisition is the evasion or avoidance of Federal income tax resulting from a deduction, credit, or other allowance which would not otherwise be available. The term “allowance” generally means any tax benefit provided by domestic tax law.

The advice concludes that the reduction or elimination of withholding tax on dividends paid by the top-tier U.S. corporation to its foreign parent would not have been available but for the acquisition of several corporations. Those corporations derived active foreign business income. Once the group was in place, the parent managed the dividend stream of subsidiaries so that it received only dividends derived from active foreign business income. Consequently, the advice concludes that reduction of dividend withholding tax was the principal purpose of the acquisition. Hence, dividends paid by the top-tier U.S. corporation must be subject to withholding tax of 30% by reason of Code §269.

f. Payments for a covenant not to compete in the U.S. were subject to withholding tax.

In 199947031, the office of the Associate Chief Counsel (International) concluded that non-compete payments made to a Swiss company was subject to 30% withholding tax to the extent the non-compete related to activities in the U.S.

In reaching its conclusion, the Technical Advice Memorandum determined that the payments constituted neither industrial or commercial profits nor royalties within the meaning of the Switzerland-U.S. income tax treaty then in effect. The payments could not be industrial or commercial profits because such profits are derived from the active conduct of a business. The essence of a non-compete agreement is an agreement to refrain from engaging in business. Consequently, the memorandum concludes that consideration for an agreement not to engage in an active business cannot be characterized as business profits. Rather, it is income from a form of property interest. The non-compete payment was not a royalty because it did not fit within the definition of royalty payments in the treaty. The term “royalty” is defined to mean the right to use copyrights, artistic and scientific works, patents, designs, plans, secret processes and formulae, trademarks, and other like property and rights. Income from non-compete agreements is not explicitly mentioned in the definition of royalties. All of the examples of royalties constitute income from the use or disposition of intellectual property. In comparison, a payment for the right not to compete is more akin to a franchise fee which is not similar to the items specifically enumerated. The memorandum refused to expand the definition of a royalty in the treaty to cover payments for the use of intangible property other than intellectual property.

g. A foreign company that reports effectively connected income in its tax return cannot disavow the facts represented in the return.

Maritime Grain and Trading, Limited v. Commr., T.C. Memo. 1999-322, is a strange case involving a foreign corporation that attempted to disavow its tax return.

The taxpayer was a corporation organized under the laws of the U.K. Its mailing address was in Los Angeles, California. In its tax returns, it reported all its income as effectively connected income fully taxable in the U.S. After an I.R.S. examination made certain adjustments to taxable income, the corporation contended that none of its income was effectively connected with the conduct of a trade or business in the U.S. The Court refused to let the taxpayer disavow the characterization of income and assets in its return. The case is a warning to foreign corporations that U.S. tax return preparation should be attended to seriously.

h. More corporate tax shelter strategies successfully challenged by I.R.S.

Brokerage houses and accounting firms have numerous financial products designed to reduce corporate tax on capital gains. In most instances, the product is based on the creation of a capital loss from a fully planned series of transactions. The loss reflects a technical application of various provisions of the tax law.

Taxpayers who are examined have had little success in overcoming I.R.S. challenges. Several additional shelter schemes were dismissed as shams in Compaq Computer Corporation v. Commr., 113 T.C. ___No. 17 (September 21, 1999), IES Industries Inc. v. U.S., ___ F. Supp. ___ (September 22, 1999 Docket No. C97-206), and Saba Partnership v. Commr., T.C. Memo 1999-359.

Compaq derived a long-term capital gain, which would have been subject to a 35% tax in the absence of planning. An investment banking firm provided Compaq with a financial vehicle that was designed to produce a technical loss. In the transaction, Compaq purchased ADR's "cum dividend," followed by the immediate resale of the same ADR's "ex dividend." "Cum dividend" refers to a purchase or sale of a share of stock or an ADR share with the purchaser entitled to a declared dividend (settlement taking place on or before the record date of the dividend). "Ex dividend" refers to the purchase or sale of stock or an ADR share without the entitlement to a declared dividend (settlement taking place after the record date). Compaq purchase 10 million ADR's of Royal Dutch Petroleum Company, cum dividend, for $887,577,129. It immediately sold the ADR's ex dividend for $868,412,129. At the same time Compaq became entitled to a dividend of $22,545,800, subject to a 15% withholding tax. On its tax return, Compaq reported a short term loss that offset the capital gain, foreign source dividend income, and a foreign tax credit. The Court's discussion focused on the foreign tax credit.

The Court adopted the I.R.S. view that Compaq was not entitled to the foreign tax credit because the ADR transaction had no objective economic consequences or business purpose other than reduction of taxes. In so holding, the Court evaluated the profit motive of Compaq by looking at its return, treating the foreign tax credit as an expense. Looked at in this way, Compaq lost money and could not have done other than lose money when gains, losses, dividends, taxes and other expenses are taken into account. In other words, the profit motive analysis was performed on a financial accounting basis rather than a tax return basis. The Court rejected Compaq's argument that pretax income is the standard and on that basis almost $2.0 million was made. Following Compaq's logic to conclusion, the $2.0 million of profit was subject to a combined Dutch and Federal income tax of $4.0 million. This made no sense to the Court. In sum, the Court viewed the investment as an attempt to "capture" a foreign tax credit by timed acquisition of ADR's cum dividend and the sale of ADR's ex dividend. The taxpayer's goal was to acquire a foreign tax credit, not substantive ownership of Royal Dutch ADR's.

IES Industries involved a motion for summary judgment brought by the Government in a refund claim. There, the taxpayer purchased ADR's with dividend rights attached, and then promptly re-sold the ADR's without the dividend rights at prearranged prices. The sources for the ADR's were entities that were exempt from US income taxes, such as pension funds. While exempt from U.S. tax, these entities were nonetheless subject to a 15% foreign withholding tax on the ADR dividends. While U.S. taxpayers are generally entitled to a foreign tax credit under these circumstances, that credit is of no use to these entities that pay no U.S. income tax in the first instance.

The ADR trading provided a mechanism whereby the right to the foreign tax credit could be transferred from the tax-exempt entity that could not use it, to IES, which could use it. Through ADR trading, IES would buy a dividend worth $1 for 85 cents. It would receive the 85-cent dividend, and claimed an additional 15 cents as a foreign tax credit on its U.S. tax return. Excluding transaction costs, IES would have a capital loss of 85% of the dividend resulting from the prompt resale of the ADRs. It could use the capital loss as an offset against other preexisting capital gains.

The Court viewed the transactions as shams. They were shaped solely by tax avoidance considerations, had no other practical economic effect, and were properly disregarded for tax purposes. As an aside, the Federal Government requested recoupment of the tax attributable to deductions allowed for out of pocket expenses incurred in connection with the transactions. Those expenses were incurred in years for which the statute of limitation barred collection of additional tax. However, the taxpayer was entitled to a refund of Federal tax for the year in issue as a result of other circumstances. The Court granted a Government motion for equitable recoupment, allowing it to avoid paying a dividend up to the amount of the deficiency barred by the statute of limitations.

In Saba Partnership, the Tax Court had before it a Merrill Lynch scheme to reduce corporate tax on capital gains. The scheme involved the creation of a partnership with a foreign entity, the purchase and installment sale of assets, and the application of installment sales rule that accelerate gain and then provide for amortized loss over the balance of the installment period. As the gain is recognized while the partnership is principally held by a foreign entity, the gain is tax free. Thereafter, the foreign partner reduces its interest in the partnership and the amortization is allocated principally to the U.S. entity wishing to shelter capital gains.

As with other taxpayers who implemented the scheme in other partnerships, the losses were disallowed. The Tax Court held that the disputed transactions were not motivated by legitimate non-tax business purposes and were not imbued with objective economic substance. Rather, they were shams that are not respected for Federal income tax purposes.

i. Withholding tax does not apply to payments made to offshore trade creditors by a bankrupt company

In Private Letter Ruling 199942055, the I.R.S. ruled that payments to trade creditors by a corporation operating under a chapter 11 bankruptcy plan are not subject to withholding tax in the U.S.

In the ruling, the U.S. company was a member of a foreign-based group. It was acquired to purchase products made by affiliates, subject the products to further processing, and to sell the finished products in the U.S. Typically, a U.S. company buying goods from a foreign vendor must post an irrevocable letter of credit as payment. However, the taxpayer's financial situation was not good and it was difficult or impossible for the U.S. company to obtain an letters of credit. Consequently, its parent corporation would finance the U.S. company's purchases under an internal trade acceptance financing arrangements, under which it agreed to accept the U.S. company's commercial paper and on that basis paid the vendors. In effect, the taxpayer's acceptance made the bill of exchange the equivalent of a promissory note. At times, the trade acceptances would be sold at a discount and generally with recourse to the foreign parent. The trade acceptances did not bear interest and initially carried a 30-day term. The term was lengthened to 180 days as the financial position of the U.S. company became more and more tenuous.

Eventually, the taxpayer's financial condition worsened and the company was sold with the understanding that the taxpayer would promptly file a Chapter 11 bankruptcy petition. The foreign parent was a general creditor, filed a claim, and likely will receive only a portion of the amounts due from the U.S. corporation. The I.R.S. ruled that no portion of the payment will be subject to U.S. withholding tax.

Ordinarily when a debt obligation arises from the transfer of non-traded property, the obligation must bear stated interest payable at regular intervals or it will be deemed to have an original issue discount element. OID is the functional equivalent of interest. OID is generally taxable to a foreign person at the time payments are made on an indebtedness. An exception exists, however, for OID on short term instruments. The OID is not subject to withholding tax if the maturity of the instrument is 183 days or less from the date of issuance.

The issue presented to the I.R.S. was whether the commercial paper held by the foreign parent corporation amounted to a long term indebtedness because all the paper should have been aggregated or whether each paper issued by the U.S. company was a separate instrument. If the latter, the paper would be considered to be short term OID not subject to withholding. If the former, a 30% withholding tax would be due to the extent of accrued OID. The I.R.S. determined that each paper should be looked at separately. There was no overall credit agreement and each paper was separately negotiated. They contained varying credit terms, depending on the financial condition of the U.S. company at the time of negotiation. Accordingly, the I.R.S. concluded that the acceptances should not be aggregated for purposes of determining whether the debts include an OID or imputed interest component. Consequently, no withholding tax was due.

j. <u>German insurance company exempted from excise tax on receipt of insurance premiums</u>.

In Private Letter Ruling 199946020, the I.R.S. ruled that a German insurance company was actively engaged in the insurance business and was entitled to the exemption from excise tax provided under the Germany-U.S. Income Tax Treaty.

In the ruling, the taxpayer was a corporation that was resident in the Federal Republic of Germany. It wrote property and casualty insurance. The taxpayer represented that it was engaged in an active trade or business in Germany and that the premium income from U.S. insureds was derived in connection with, or is incidental to, that trade or business and exempt from the excise tax by reasons of Article 28(l)(c) of the Convention.

The ruling applied the standard expressed in Rev. Proc. 92-39, sec. 3.06, 1992-20 I.R.B. 24, to conclude that the German corporation was actively engaged in the insurance business. Under that standard, the average of certain ratios must exceed 25% with no ration being less than 20%. The first ratio compares the average value that the assets of the insurer used or held for use in the active conduct of a trade or business in Germany during the taxable year to the value of all its assets. The second ratio compares gross premiums received by the insurer for policies on risks situated in Germany to total gross premiums received. The third ratio compares the insurer's payroll and commission expense paid to employees and agents for services performed in Germany to the insurer's worldwide payroll and commission expense.

k. Miscellaneous restructuring.

The I.R.S. has issued the following restructuring rulings.

In Private Letter Ruling 199939017, the I.R.S. treated a transaction by which a consolidated group's dual-resident holding company structure was replaced with a domestic holding company as a tax-free parent subsidiary liquidation.

In Private Letter Ruling 199939005, the I.R.S. treated a transaction by which domestic and foreign businesses were combined as a partial redemption under Code §304(a)(1) followed by a tax-free transfer of assets subject to Code §351(a).

6. Miscellaneous Individual Transactions.

a. U.S. company does not recognize gain on the grant or exercise of nonqualified stock options involving shares of its foreign parent.

In Field Service Advice 199941033, the office of Assistant Chief Counsel (Employee Benefits and Exempt Organizations) considered the tax treatment to a U.S. employer of a nonqualified stock option plan involving shares of its foreign parent. Typical for this type of plan, the options were determined not to have an ascertainable value at issuance. Consequently, the employee's income was deferred until the option was exercised. At that time, the excess of fair market value of the shares over the exercise price would constitute taxable income for the employee and a deduction for the employer.

Under the plan, employees who exercised options paid the exercise price directly to the foreign parent company, which then transferred its shares directly to the employees. The company claimed compensation expense equal to the amount taken into income. This treatment is warranted by Regs. § 1.83-6(d)(1), which addresses bargain purchases by an employee of property held by a shareholder of the employer. In this set of triangulated circumstances, the regulations treat the shareholder as having made a capital contribution to the employer which sells the property to the employee at a bargain. Hence, the bargain element results in compensation income for the individual and compensation expense for the employer.

The issue here arose from a technical application of the basis rules. A corporation is deemed to have a zero basis in its own shares. Consequently, when the shares of the foreign parent were deemed to be contributed to the capital of the U.S. subsidiary, the subsidiary also had a zero basis. Upon examination, the I.R.S. examiner contended that the U.S. company must recognize gain equal to the fair market value of the shares. The company would be entitled to the compensation expense deduction claimed.

The Field Service Advice concludes that the transaction is covered by Rev. Rul. 80-76, 1980-1 C.B. 15. That ruling holds that a majority shareholder of a corporation recognizes no gain or loss on its transfer of stock of the corporation to an employee of a subsidiary, but must allocate its basis in the transferred stock to any shares that it retains. The ruling additionally holds that the subsidiary-employer is entitled to deduct the amount includable in the employee's gross income and, "because section 83 applies," does not recognize gain or loss as a result of the transfer. The I.R.S. is considering new regulations which will adopt a cash model for the type of transaction in issue. Under that model, the parent would be deemed to issue cash to the subsidiary and the subsidiary would be deemed to have acquired the property with that cash. However, the regulations have not been adopted. Until final regulations are issued, the ruling is dispositive.

b. Treatment of compensation payments received by U.S. citizens from international organizations for U.S. income tax purposes explained.

Compensation provided to employees of international organizations commonly consists of a nominal gross salary, which is subject to a mandatory reduction. All employees are subject to the reduction. Amounts representing the reduction are retained by the organizations for their own use. The reduction is neither credited to nor used for the benefit of the particular employee to whose compensation it was applied. Thus the employee's gross salary is a fiction.

Employees of international organizations who are citizens of the United States must pay U.S. Federal income taxes and state and local taxes on their compensation. Employees of international organizations who are not U.S. citizens are generally not subject to U.S. federal, state or local taxation. In order to provide comparable net compensation to all their employees, international organizations commonly reimburse U.S. employees for their federal, state and local taxes. The amount of a U.S. employee's tax reimbursement may be based on an approximation of the employee's tax liabilities.

In the past, the I.R.S. advised that it was acceptable to report the amount of an international organization employee's gross salary, rather than an amount that reflects the mandatory reduction and the tax reimbursement. The I.R.S. has now retreated from that position. In Significant Service Center Advice 199926653, the office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) concluded that reportable compensation for employees of international organizations who are U.S. citizens is gross salary, reduced by the mandatory reduction, and increased by the tax reimbursement paid during the year.

The compensation employees receive from international organizations is not subject to FICA tax. In order to provide employees with social security coverage, Code §1402(c)(2)(C) extends the definition of a trade or business for determining Self-Employment Contributions Act ("SECA") taxes to include employment with an international organization. Consequently, employees of international organizations who are U.S. citizens should report their compensation on line 7 of Form 1040, as "wages, salaries, tips, etc.," and on Schedule SE.

c. <u>Treatment of social security payments to Canadian residents who are U.S. citizens explained</u>.

The Canada-U.S. Income Tax Treaty covers the taxation of social security benefits. As the treaty has been renegotiated over the years, the method of taxation has not been consistent. Prior to the Third Protocol signed in 1995, each country had the exclusive right to tax social security benefits paid to its residents by the other country. The Third Protocol changed from a residence-based system to a source-based system, effective January 1, 1996. Under the Third Protocol, the country that paid benefits to residents of the other country had the exclusive right to tax the benefits.

The Fourth Protocol returned to a residence-based system under which social security benefits are taxable exclusively in the country where the recipient resides. The changes made by the Fourth Protocol are generally retroactive to January 1, 1996. However, benefits paid during 1996 and 1997 are not subject to a higher rate of tax than was imposed under the Third Protocol. Individuals who received benefits during 1996 and 1997 that would be subject to a lower rate of tax under the Fourth Protocol are generally entitled to refunds.

The Fourth Protocol addresses the payment of refunds of source-state tax with respect to "source-taxed benefits." In the case of Canadian residents who are entitled to refunds of U.S. tax withheld on U.S. social security benefits, the Canadian competent authority is authorized to apply for refunds on their behalf and to remit the refunds to them after deducting additional Canadian tax that may be imposed as a result of the benefits being subject to tax in Canada. The Technical Explanation of the Fourth Protocol issued by the Treasury Department indicates that the Canadian competent authority may base its refund claims on information received from individual Canadians as well as on information provided by the U.S. competent authority.

The U.S. and Canadian competent authorities have established procedures for implementing the refund provision. In the case of refunds claimed by Revenue Canada on behalf of individual Canadian residents, the competent authority agreement contemplates that the I.R.S. will make a separate determination as to whether each particular individual is entitled to a refund. The Philadelphia Service Center has been designated to process refund claims submitted by Revenue Canada on behalf of Canadian residents whose U.S. social security benefits appear to be subject to less tax under the Fourth Protocol than under the Third Protocol. Some of these Canadian residents are U.S. citizens.

In Significant Service Center Advice 199932046, the office of Associate Chief Counsel (International) concluded that the "saving clause" does not apply to the taxation of social security benefits paid by the United States to U.S. citizens who are resident in Canada. The saving clause provides that Canada and the U.S. may tax their residents, and, in the case of the United States, its citizens, as if the Treaty had not taken effect. Under the Fourth Protocol, such benefits are taxable only by Canada without regard to whether the recipient is a U.S. citizen. The obligation to refund taxes if so requested by Revenue Canada extends to taxes remitted directly by individual Canadian residents with respect to U.S. social security benefits that they received during 1996 and 1997.

The right to refunds, however, is not absolute. No refunds will be paid if the taxpayers owe other taxes to the I.R.S. or if the taxpayers previously requested refunds on their own that were offset against their balances due for prior years, even those for which the statute of limitations on collection has expired.

d. <u>Taxation of endorsement income of artistes and athletes explained in the context of an income tax treaty</u>.

In Technical Assistance Memorandum 199938031, the office of the Associate Chief Counsel (International) explained its views regarding endorsement income of artistes and athletes.

If an item of endorsement income is closely and proximately related to a performance by an artiste or athlete in the U.S., it should be taxed under the provision of an income tax treaty applicable to the income of artistes and athletes deriving income in that capacity. Although treaty language may not mention endorsement income in the artistes and athletes article, endorsement revenue is subsumed into that category if it is closely linked with that performance and could not be earned in the absence of the performance. An example is a soccer player receiving a definite amount of money for wearing a company's clothing during a soccer game in the U.S.

On the other hand, if the income does not have a proximate relationship with a performance in the U.S., it generally should be classified under another treaty article, such as Independent or Dependent Personal Services or Royalties, as appropriate.

The I.R.S. position is illustrated by the following example. Assume that a U.S. recording company agrees to pay a nonresident alien musician (1) a fee to present a concert in the United States, (2) a fee to show the company's logo on a large screen over the stage during the concert, and (3) a royalty on sales of recordings made of the concert. The first fee would simply be classified as income for the performance of services as an artiste. The second fee would be directly linked (i.e., proximately related) to the performance. But for the performance, the fee could not have been earned. Consequently, it too is income subject to the artistes and athletes article. The royalty, by contrast, would be associated not so much with the performance or the musician's physical presence in the U.S. Rather, it is a separate intangible created from the performance. This intangible, the copyright owned by the musician, could be exploited beyond the time of the actual performance. Thus, the royalty would be classified as royalty income under a treaty.

Once the appropriate treaty income classification for each type of endorsement activity is determined, there remains the issue of determining how much income should be allocated to each classification. A single endorsement contract may involve a mixture of activities. The contract may include a breakdown with separate amounts specified for each activity, or the contract may simply enumerate the activities that must be performed for a stated overall lump sum. Furthermore, contracts are frequently structured with a certain amount of base pay, plus additional amounts for achieving a certain ranking, for participating in certain events (e.g., playoff matches), or for having sales of endorsed products exceed certain limits.

Where either separately enumerated amounts are not arm's length, or where the contract provides a lump sum for a group of activities, the amount of income attributable to each treaty classification needs to be determined. In such cases, for purposes of allocating income from a single endorsement contract among the various categories of treaty income, it may be necessary to look at comparable third party contracts for each endorsement activity or other relevant valuation evidence and to assign monetary values, or at least relative monetary values, to each.

In apportioning a lump sum among various rights, formulary approaches should not be used. The allocation of income among treaty classifications depends on the mixture of activities performed and upon the percentage of the whole amount that would have been paid, at arm's length, for each of the activities. The percentage of income attributable to each activity will vary depending on the facts of the case. Consequently, the office of Associate Chief Counsel (International) opposes the holding in J.A. Kramer v. Commr., 80 T.C. 768 (1983), creating a bright line test that endorsement income should be allocated 70% to royalty income and 30% to personal services income.

e. Character and source of a sign-on bonus determined.

In Field Service Advice 199947028, the office of the Associate Chief Counsel (International) concluded that the character and source of a sign-on bonus by a professional athlete should be determined by the services performed in the first year of the contract.

The individual was a citizen and a resident of a foreign country. No income tax treaty existed between the U.S. and that country. The individual signed an endorsement contract with the manufacturer of sports equipment. The contract called for the payment of a specific annual fee. In addition, it provided a one-time bonus for signing on with the company. Previously, the individual endorsed the product of a competing company. Although no income tax treaty was in existence that covered the individual, he contended, nonetheless, that concepts of the Model Income Tax Treaty would cause the sign-on bonus to be treated as other income, taxable exclusively in the country of residence.

The advice dismissed the approach of the taxpayer. If no income tax treaty existed, the individual must rely on tax concepts in the U.S. In Linseman v. Commr, 82 T.C. 514, 522 (1984), the Tax Court was asked to fashion a reasonable method for sourcing a sign-on bonus paid by a domestic hockey team to a foreign hockey player as an inducement to enter into a 6-year employment The Court adopted a method that was based on the number of games the team contemplated playing within and without the United States during the first year of the contract. The advice concluded that a similar approach was appropriate for endorsements.

f. Expatriate rulings issued.

The U.S. tax rules regarding expatriation provide that the expatriation will be presumed to have been effected for a principal purpose that includes tax avoidance if the individual has a net worth ion excess of a specified amount, $500,000 adjusted for inflation. The presumption does not apply if an individual is included in certain described classes and submits a request for an I.R.S. determination that tax avoidance is not one of the principal purposes of the expatriation. At one time, the I.R.S. issued definitive rulings as to the presence or absence of a tax avoidance motive. This policy was changed in Notice 98-34, 1998-27 I.R.B. 40. Now, the rulings address only the presumption. If full and complete disclosure of facts is made, the presumption is not applicable. However, a definitive determination is generally not made. None of the rulings contain a recitation of facts. Examples of this type of ruling are Private Letter Rulings 199932035, 199932027, 199932040, and199936049. In Private Letter Ruling 199948033, the presumption was found to be inapplicable because of a full and complete disclosure. However, the disclosure indicated that tax avoidance was a principal purpose of expatriation. Consequently, the I.R.S. ruled that the expatriation rules expressly applied to the individual.

g. Portugese nationals may pay tax on social security benefits as U.S. residents under specified conditions.

In Technical Assistance Memorandum 199935058, the office of the Associate Chief Counsel (International) concluded that Portugese national may elect to be treated as U.S. residents with regard to social security payments received from the U.S.

In the case, the taxpayers were Portuguese citizens and residents who were at one time admitted to the U.S. as lawful permanent residents under the green card test. When they left the U.S., they did not relinquish their green cards. These individuals were receiving U.S. social security benefits. They claimed they should be treated as resident of the U.S. for purposes of determining how their benefits are taxed. If they are treated as residents, a portion of their benefits (0, 50%, or 85% depending on their income level) will be taxed at graduated rates on a net basis. If, on the other hand, the taxpayers are treated as nonresidents, 85% of the gross amount of their benefits will be subject to a 30% withholding tax.

The examiner was advised that the individuals may be treated as residents of the U.S. if (i) they refrain from claiming any benefits under the Portugal-U.S. Income Tax Treaty, (ii) they file U.S. tax returns as residents and pay U.S. income tax on a net basis on their worldwide income, and (iii) their status as lawful permanent residents has not been revoked or abandoned. The determination of whether the taxpayers' status as lawful permanent residents has been revoked or abandoned must be made under the immigration laws of the United States, which are administered by the Immigration and Naturalization Service.

h. <u>Information obtained under treaty cannot be disclosed prior to trial</u>.

In Field Service Advice 199941003, the office of the Associate Chief Counsel (International) addressed disclosure of information to a taxpayer prior to trial.

The information was obtained from a foreign tax authority under an exchange of information program. It was requested as part of the informal pretrial discovery prior to a trial in the U.S. Tax Court. The advice was that the information could not be disclosed. The information exchanged under the treaty must be treated as secret. Nonetheless, disclosure to courts and administrative bodies is permitted. As a practical matter, however, disclosure was not going to be made out of concern that the taxing authorities abroad would be less cooperative in responding to future requests if information was disclosed contrary to their wishes.

i. <u>Survivor benefits paid to German resident are not taxable</u>.

In Field Service Advice 199947009, the office of Associate Chief Counsel (International) concluded that survivor benefits paid to an individual resident of Germany were not taxable.

The matter involved an individual who was born in Germany and lived in the U.S. for several years. She became a naturalized U.S. citizen. Ultimately, she returned to Germany and formally renounced her U.S. citizenship. At that time, she stated she was a resident of Germany. The individual received monthly survivor benefit payments from the U.S. government. Federal income tax was withheld from those payments. A tax return was filed claiming a refund based on the Germany-U.S. Income Tax Treaty.

The advice concluded that treaty benefits were available. Under Article 18(1), pensions derived and beneficially owned by a resident of Germany are taxable only in Germany. Accordingly, assuming the individual was a resident of Germany, her survivor benefits were not taxable by the U.S. However, if the individual's loss of U.S. citizenship had as one of its principal purposes the avoidance of income tax, the "saving clause" in paragraph 1(a) of the protocol to the treaty would allow the U.S. to continue to tax the survivor benefits for ten years after citizenship was relinquished.

j. <u>A model and an actor in industrial promotional films is not covered by the artiste and athlete article of an income tax treaty</u>.

In Field Service Advice 199947027, the office of the Associate Chief Counsel (International) considered the status of a model and actor under an income tax treaty. The issue was whether the individual was covered by the artiste and athlete article under which relevant income would be taxable in the U.S. or under by another article that could exempt the income. The advice concluded that the individual was not an entertainer and accordingly the independent personal services article was applicable.

The individual was a model and actor. She was engaged as an image spokesperson for a U.S. corporation in connection with the "advertising, marketing, promotion, publicizing, merchandising, and distribution" of products. Under the terms of the engagement, she was required to appear in the media and be associated with the product. She was required to meet with senior corporate managers for orientation sessions every year.

She filed a U.S. tax return in which her occupation was listed as “actor.” She claimed an exemption from taxation in connection with the fees received from the U.S. corporation on the grounds that the income was a royalty that was exempt under applicable treaty.

The I.R.S. approached the issue by first determining whether the income in issue was properly characterized as income of an artiste or athlete from the performance of services in that capacity. Looking to the explanation of the O.E.C.D. Model Convention for the Avoidance of Double Taxation and Fiscal Evasion, the advice concluded that the activities of an artiste mus have "entertainment character." Entertainment value was missing from the taxpayer’s arrangement with the U.S. corporation. The primary purpose of the individual’s activities was to promote, market, and sell products. Merely because the contract referred to the individual as a model and performer did not change the primary purpose of the contract.

Having reached that conclusion, the advice indicated that the fees likely constituted independent personal services for which the individual could be taxed if a fixed base existed in the U.S. The fee did not constitute royalties.

7. <u>Administration tax proposals.</u>

a. <u>Tax havens</u>.

The administration proposes the imposition of a taxpayer reporting requirements for payments made to entities, accounts or individuals resident or located in certain tax havens that have been identified in a list of jurisdictions to be published by the I.R.S. These are tax havens that do not cooperate in exchanging information on criminal tax matters. Failure to report a payment subject to these rules would result in a penalty on the payor equal to 20% of the amount of the payment. The Administration also proposes to deny a foreign tax credit for taxes paid to the identified tax haven jurisdictions. The foreign tax credit limitation rules separately to income earned in or through such a tax haven jurisdiction. The proposal also would restrict foreign tax credits, foreign sales corporation benefits, and deferral benefits for income attributable to a tax haven.

b. Trafficking in built-in losses.

The administration proposes to limit the ability of taxpayers to use foreign built-in losses and other tax attributes that accrue outside the U.S. taxing jurisdiction. A fresh start would be provided for all tax attributes and basis when an entity or an asset first becomes relevant for U.S. tax jurisdiction.

It also proposes to simplify taxation of property that no longer produces income effectively connected with a U.S. trade or business. The proposal would mark to market property (including rights to deferred income) at the time that the property ceases to be used in, or attributable to, a U.S. trade or business.

c. Limit basis step-up for imported pensions.

The administration proposes to provide that an individual would have basis with respect to a distribution from a foreign pension plan only to the extent that the individual previously has been subject to tax (either in the United States or the foreign jurisdiction) on the amounts being distributed.

d. Impose mark-to-market exit tax on individuals who expatriate.

The administration proposes to repeal the current expatriation tax provisions for individuals and in its place impose a mark-to-market exit tax on unrealized gains existing at the time of expatriation, without regard to the expatriate's subjective motivation. The proposal would also treat certain gifts made by an expatriate to U.S. persons as taxable income to the recipient.

e. Expansion of scope of effectively connected income.

The administration proposes to expand the categories of foreign- source income that could constitute effectively connected income under Code §864(c) to include economic equivalents of interest and dividends for financial institutions. In addition, the proposal would include as U.S. source income any income that is attributable to a U.S. office or other fixed place of business.

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