

International Tax

Chapter 8

~~DISC's~~
~~Terminated~~

~~Current DISCs and IC~~
~~DISCS in 2018—~~
~~terminated.~~

NO Change

100% Exemption
(via DRD)
for Foreign-Source
Non-Subpart F
Dividends
(- \$215.5 Bil. over 10 years)

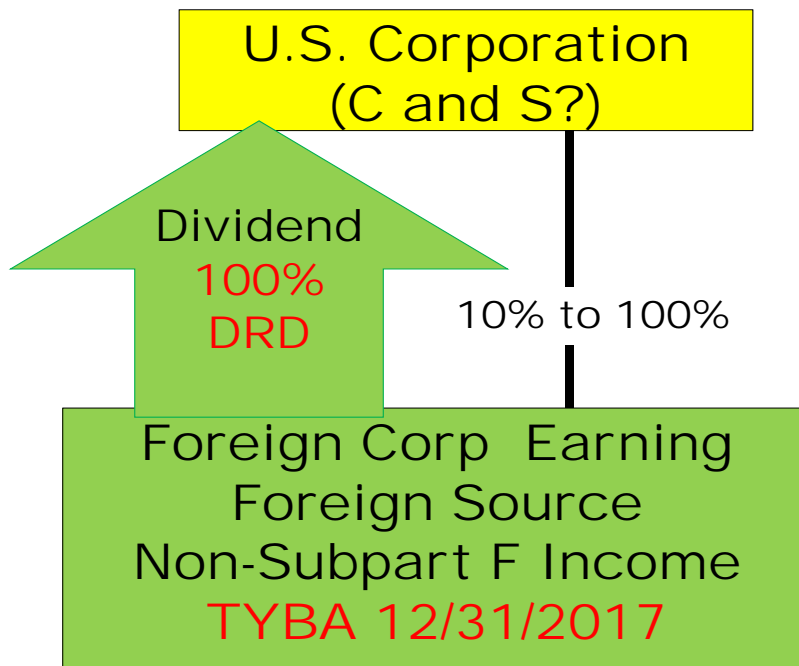
3

- SFC exempts (via 100% DRD) 100% of the foreign-source portion of dividends received by a U.S. corporation from a foreign corporation in which the U.S. corp. owns at least 10%.
- Most hold foreign stock one year.

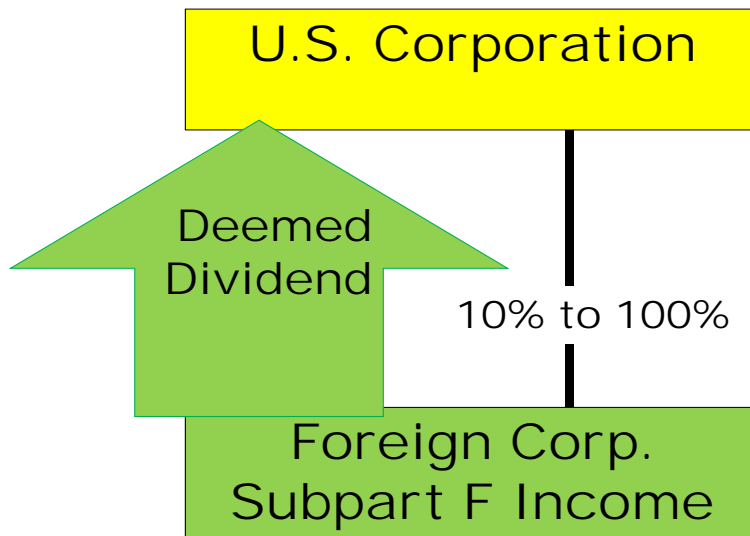
4

- No exemption if the “dividend” is deductible by foreign corporation in computing foreign tax (“hybrid dividend”).
- Effective TYBA Dec. 31, 2017

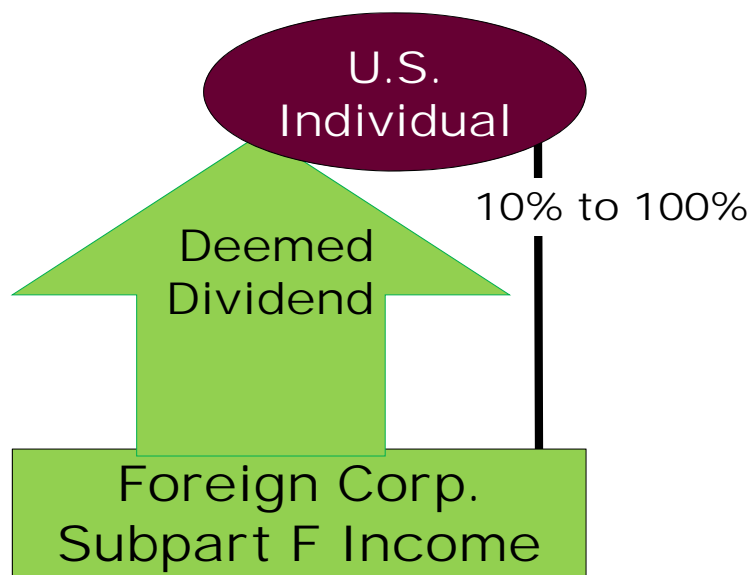
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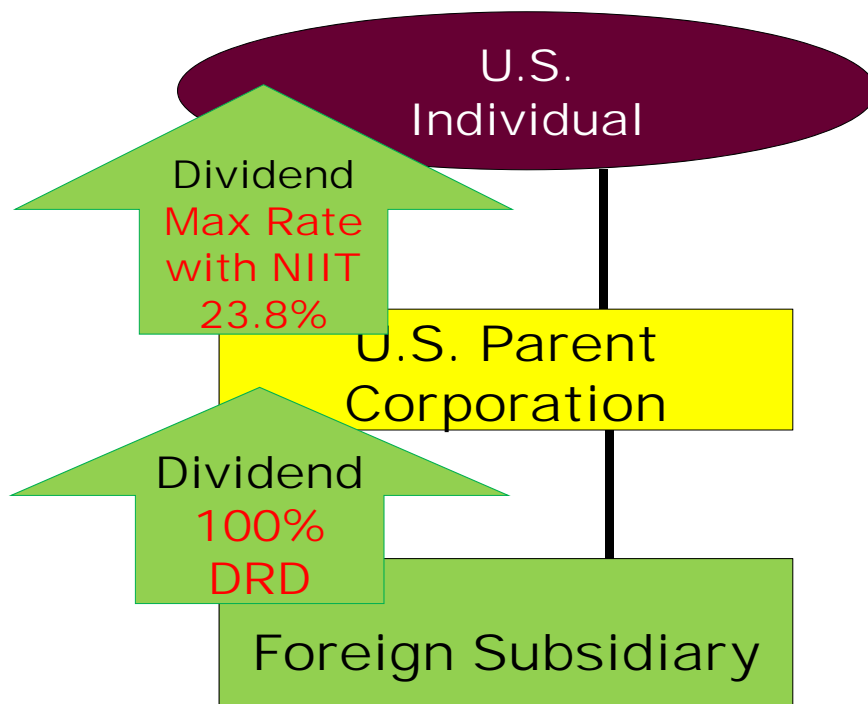
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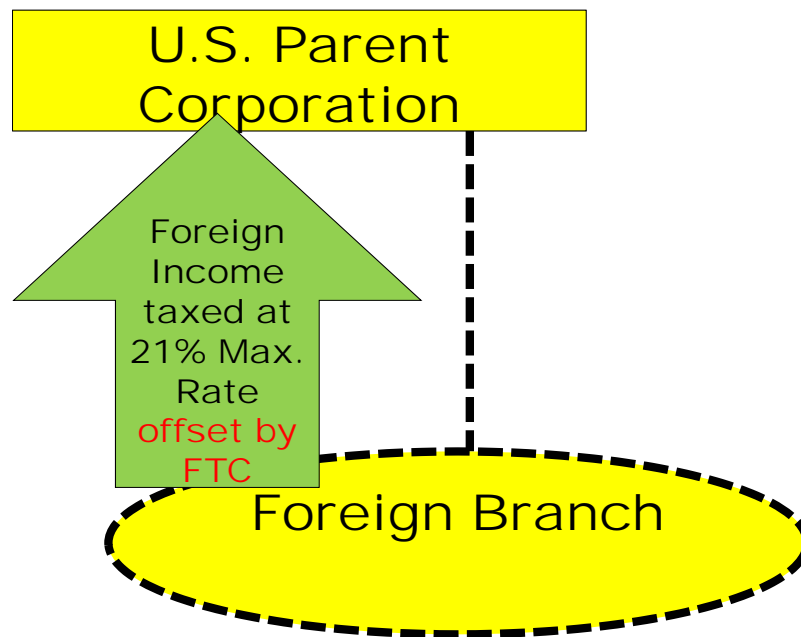
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What about a
foreign branch?

10

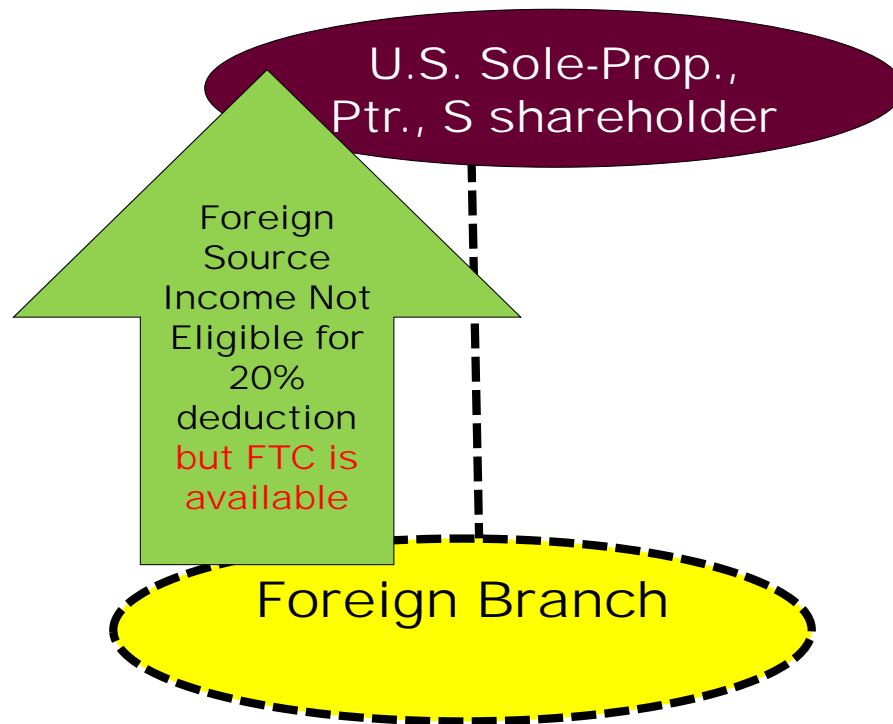


If foreign rate is lower than 20%, then U.S. tax on the difference.

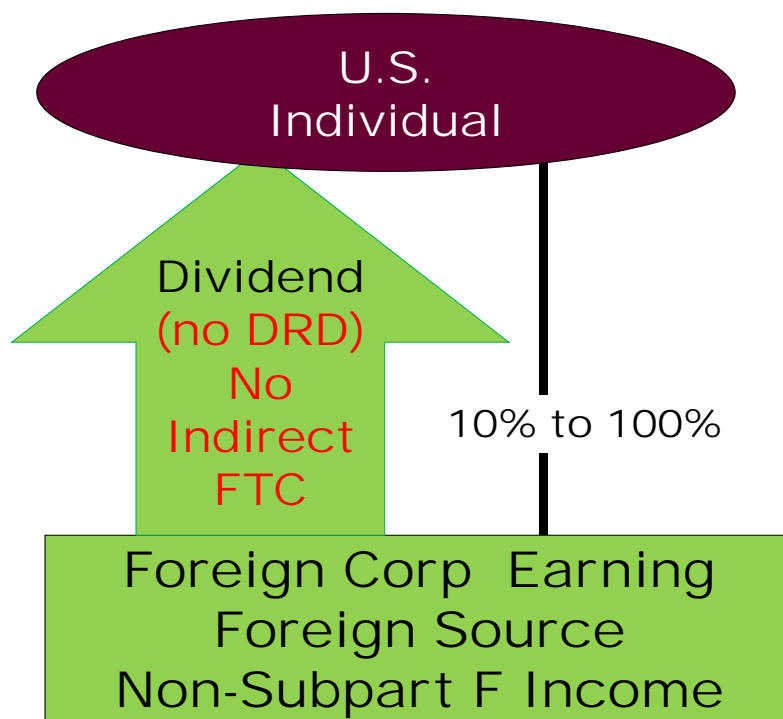
11

What about a U.S.
"pass-thru"?

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14

Transition Tax On Deferred Foreign Income (Sec. 965) (+ \$184.8 Bil.)

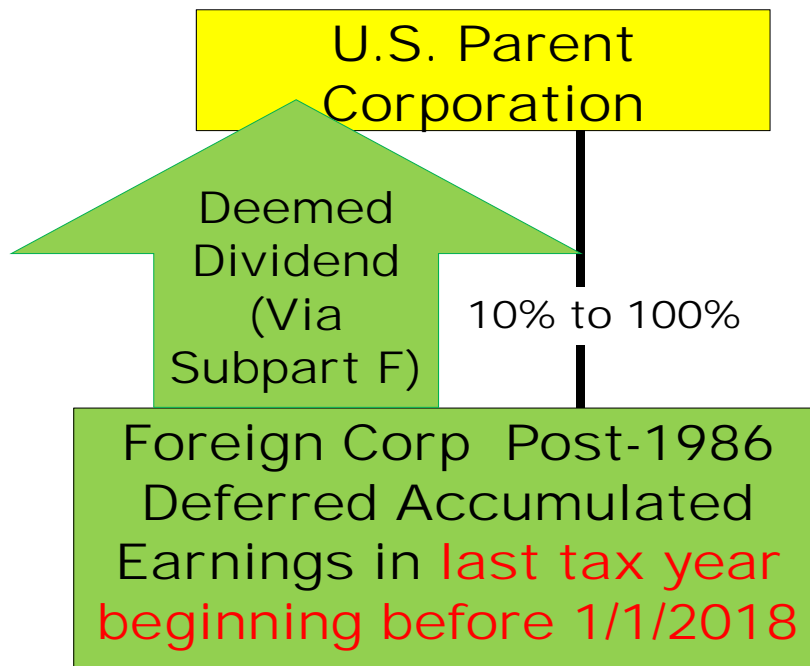
15

- One-time tax on a US shareholder owning at least 10% of a foreign corporation on the shareholder's pro rata share of the foreign corporation's post-1986 tax-deferred earnings.
- Rate is 15.5% (if accumulated earnings held in cash or cash equivalents) or 8% (if accumulated in illiquid assets).

16

- The tax can be paid over 8 years and a portion of FTCs are available.
- Shareholder with 10%-or-greater stake in a corporation with post-1986 accumulated deficits can offset accumulated earnings.
- Pay tax at 35% rate if U.S. corp. **inverts** within 10 years after enactment.

17

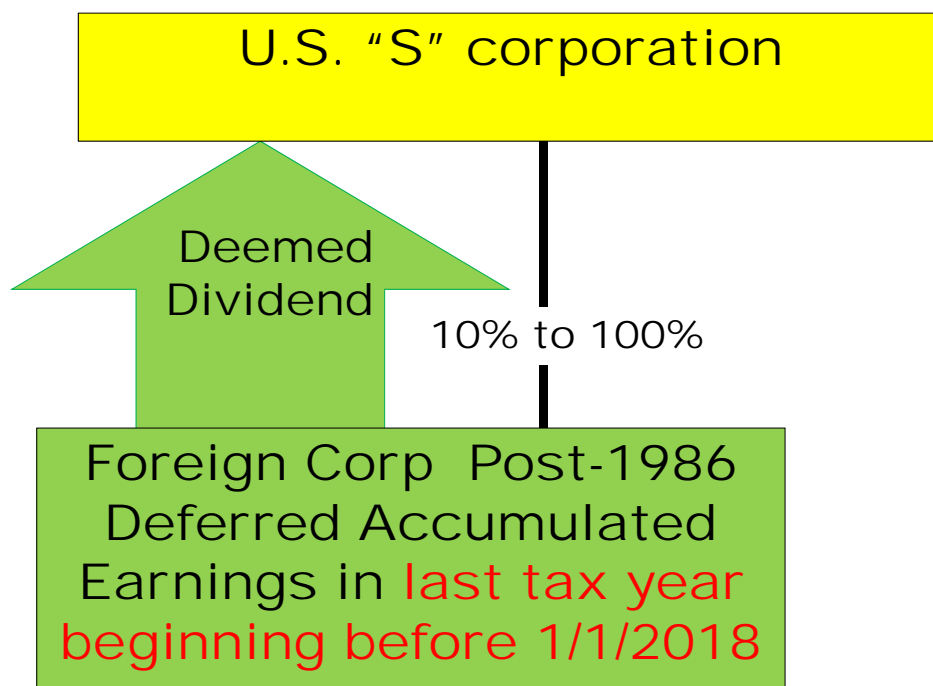


18

Special Rule for S Corporations

Any **shareholder** of an S corporation can elect to **defer the "transition net tax liability"** until a triggering event occurs—S status change, liquidation, termination, transfer of shares...

19



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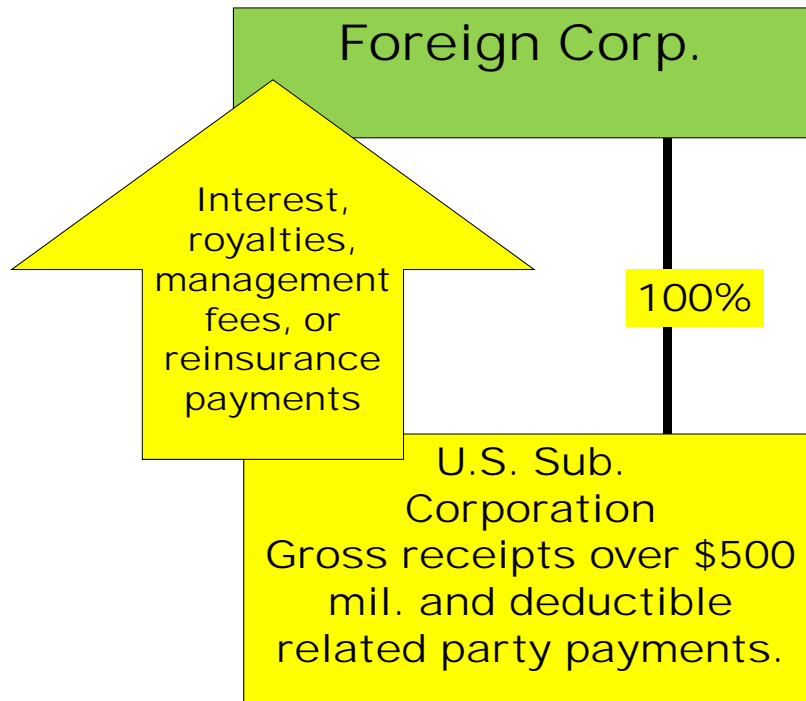
Base Erosion and Anti-
abuse Tax
(aimed at inbound
earning stripping)

(+137.6 Bil. Revenue)

21

Proposed 12.5% tax (per Senate) is aimed at foreign-owned U.S. subsidiaries that reduce their U.S. tax liability by making unreasonably large deductible payments (but not cost of goods sold) to a foreign parent (or foreign affiliates) – AKA Earnings Stripping

22



23

Current Year
Inclusion of Global
Intangible Income
(GILTI) income
(+ \$135.5 billion)

24

A U.S. shareholder of CFC must currently include in income its **global intangible low-taxed income (GILTI)** in a manner similar to how it includes subpart F income.

25

Essentially, companies paying less than a 10% tax on profits in foreign jurisdictions, pays that tax to the IRS.

26

- Only 80% of the foreign taxes paid on the income would be allowed as a foreign tax credit.
- Excluded from GILTI: effectively connected income, subpart F income, foreign oil and gas income, or certain related party payments.
- GILTI income is taxed at a rate of 10%.

27

Deduction For Foreign-derived Intangible Income (-64.4 billion)

Incentive to bring IP back
from foreign sub to U.S.
Parent

28

A U.S. corporation is allowed a deduction equal to 37.5 percent (i.e., a preferential tax rate of 12.5 percent) on its foreign-derived intangible income earned in the United States.

29

Foreign derived intangible income is calculated in a manner similar to the global intangible low- taxed income.

30

*Grecian Magnesite Mining
(GMM), Industrial &
Shipping Co., SA, 149 TC
No. 3
(July 13, 2017)*

8-10

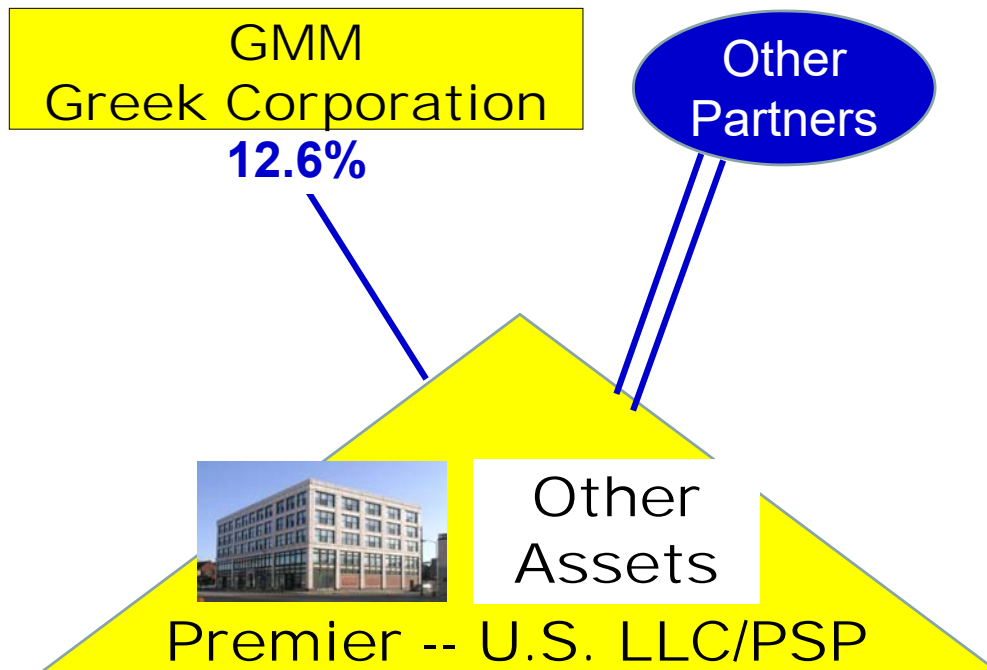
Foreign Corporation's
Disposition Of Interest In
U.S. Partnership
(55 Page Opinion)

31

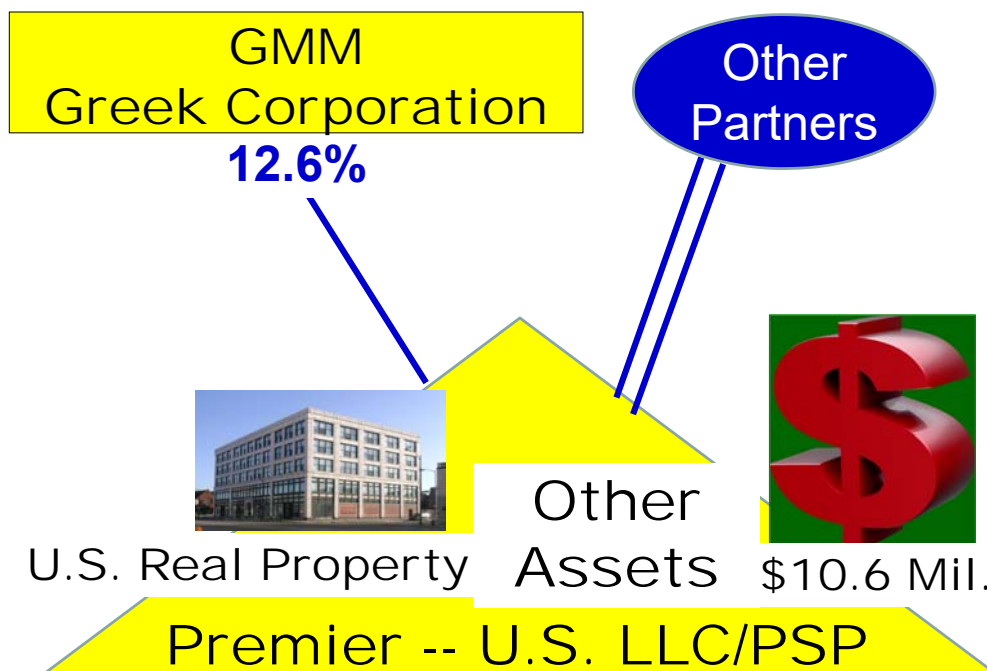
The pending Senate
Bill (11/14/2017)
reverses the impact
of this judicial
decision for sales
after 12/31/2017

32

Redemption of FC by PSP



33



34

GMM realized \$6.2 million of gain and \$2.2 million was attributable to Premier's U.S. real estate.

35

GMM stipulated at trial that the gain attributed to the U.S. Real Property was U.S. ECI (taxable) per section 897(g)

36

Tax Court Holding #1

- GMM's gain was **foreign source** based upon the **default rule in section 865** that gain on the sale of personal property is sourced based upon residence of the seller.
- And not U.S. source under the "U.S. Office rule".

37

As a result, the **\$4 mil.** of **remaining redemption gain** was not taxable by the U.S. unless **ECI**

38

IRS Position

IRS relied upon Rev. Rul. 91-32 which adopted a look-thru **approach similar to section 751** but for ECI generating assets rather than hot assets.

39

Tax Court View of Ruling

“**Rev. Rul. 91-32** is not simply an **interpretation of the IRS's own ambiguous regulations**, and we find that it lacks the power to persuade.... Its treatment of the partnership provisions ... **is cursory in the extreme, not even citing section 731**”

40

Tax Court Holding #2

GMM's proceeds from the redemption of the U.S.

LLC/PSP was **not effectively connected with a U.S. trade or business.**

41

Sequence followed by the Tax Court: section **736(b)(1)** leads to **section 731**, which in turn leads to **section 741**, "but [IRS] evidently thinks such an analysis stops short."

42

Section 741 says that gain on the sale of a PSP interest shall be considered as gain or loss from the sale or exchange of a capital asset”.

Observation: Same reasoning should protect against SE tax on redemption a U.S. partner.

43

Conference Agreement

Under the Conference Agreement gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.

44

The proposal also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest

45

The proposal is effective for sales and exchanges **after December 31, 2017**

46

Notice 2017-57
(10/2/2017)

8-2

IRS Delays Effective Date
Of Foreign Currency
Regulations and
Considers Alternative
Rules

47

*Chamber of Commerce
of the U.S. of America*
(DC TX 9/29/2017)

8-2

Anti-Inversion
Reg Held Invalid Due to
Violation of Notice and
Comment Period

48

District Court Holding

Treasury's practice of passing temporary rules effective immediately **without a 30-day notice period or opportunity for comment** (simultaneously with issuance of prop. regs.) violates the notice and comment period requirement of the APA.

So the temp. regs. are invalid!

49

Flume

TC Memo 2017-21
(1/30/2017)

8-3

U.S. Owner Of Foreign
Corporations Penalized
For Failure To Timely
File Forms 5471

50

- A U.S. Citizen living in Mexico and part owner of two Mexican corporations.
- The decision provides a helpful review of the Form 5471 filing requirements for U.S. citizens and the “reasonable cause” excuse for failing to file.

51

Tax Court's Holding

- The taxpayer lacked a reasonable cause for failing to file Forms 5471 – penalties sustained!
- He could not establish reasonable cause via reliance on his preparer's advice because he failed to tell her he owned the foreign corporations.

52

*LB&I International
Practice Unit 8-5
Knowledge Base:
"Failure to File the
Form 5471 — Category
2 and 3 Filers —
Monetary Penalty"
(Linked 10/10/2017)*

53

Category 1 Filer

None. It became
obsolete in 2004 when
Congress **repealed the
Foreign Personal Holding
Company Regime**

54

Category 2 Filer

Category 2 Filer:

- A Category 2 filer is a U.S. citizen or resident who is an officer or director of a foreign corporation in which a USP:
 - Has acquired (in one or more transactions) stock which meets the 10 percent stock ownership requirement (described below) with respect to the foreign corporation,
 - Has acquired (in one or more transactions) an additional 10 percent or more (in value or voting power) of the outstanding stock of the foreign corporation or
 - Is a U.S. shareholder under IRC 953(c).

55

Category 3 Filer

Category 3 Filer:

- A Category 3 filer is:
 - A USP who acquires stock in a foreign corporation which, when added to any stock owned on the date of acquisition, meets the 10 percent stock ownership requirement with respect to the foreign corporation,
 - A USP who acquires stock which, without regard to stock already owned on the date of acquisition, meets the 10 percent stock ownership requirement with respect to the foreign corporation,
 - A person who is treated as a U.S. shareholder under IRC 953(c) with respect to the foreign corporation,
 - A person who becomes a USP while meeting the 10 percent stock ownership requirement with respect to the foreign corporation or
 - A USP who disposes of sufficient stock in the foreign corporation to reduce his or her interest to less than the 10 percent stock ownership requirement.

56

Category 4 Filer

Category 4 Filer

A Category 4 filer is a USP who controlled a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.

57

Category 5 Filer

Category 5 Filer

A Category 5 filer is a U.S. Shareholder who owned stock in a foreign corporation on the last day of the foreign corporation's tax year when the foreign corporation was a controlled foreign corporation ("CFC") (a) on such day and (b) for an uninterrupted period of 30 days or more during such tax year.

58

IRM Quote in IPU

“Ignorance of the law,
by itself, is not
reasonable cause.
However, in
conjunction with other
factors, it might be.

59

Such other factors to consider
include: the [United States
Person's (USP's)] education, **if
the USP was penalized before,**
if the USP could not reasonably
be expected to know of recent
changes in the tax law or
forms and the level of
complexity of a tax or
compliance issue.”

60

Avrahami
149 TC No. 7
(8/21/2017)

8-6

Microcaptive
Arrangement Not
"Insurance," So Premiums
Not Deductible

61

Background

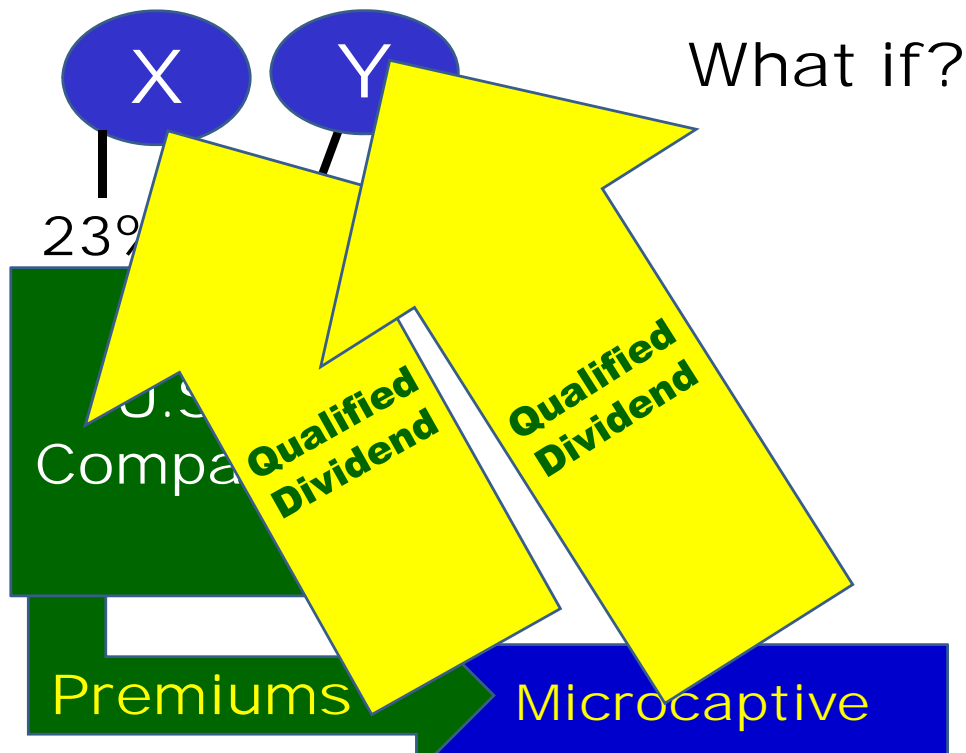
62

- Microcaptives often are incorporated in tax haven foreign countries, such as the Cayman Islands.
- The foreign microcaptives must elect under section 953(d) to be taxed as a U.S. domestic corporation.

63

“Microcaptive” =
captive insurance
company + section
831(b) election to only
be subject to U.S. tax
on investment income
(not underwriting
income).

64



General Theory:

- Pay premiums to your “foreign” (U.S. corp by election) microcaptive.
- Deduct premium under section 162.

- Microcaptive underwriting profit is exempt from U.S. tax (sec. 831(b)).
- Payments received from Microcaptive are dividends or capital gains taxed at preferential rates.

67

Section 831(b) Election Per the 2015 PATH Act:

- 1) be an **insurance company**;
- 2) have net written premiums (or, if greater, direct written premiums) for the taxable year that do not exceed \$2.2 million;

68

- 3) meet the diversification requirements; and
- 4) make or have in effect, an election to be taxed under section 831(b).

69

For the third consecutive year, **microcaptive insurance transactions** are on IRS's list of "Dirty Dozen" tax scams.

(News Release IR 2017-31)

70

November 2016 IRS issued Notice 2016-66 indicating that **certain** section 831(b) companies are "transactions of interest" requiring information reporting under sections 6011 and 6111 as "reportable transactions."
(See also Notice 2017-08)

71

The **Form 8886, Reportable Transaction Disclosure Statement**, must identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the transaction and identify all parties involved in it.

72

Per Notice 2016-66

"[T]he manner in which the contracts are interpreted, administered, and applied is **inconsistent with arm's-length transactions and sound business practices.**"

73

The IRS acknowledges that related parties may use captive insurance companies that make elections under Sec. 831(b) **"for risk management purposes that do not involve tax avoidance."**

74

Avrahami
(8/21/2017)

105 Pages

75

The Avrahamis argued that their microcaptive, Feedback, was a valid insurance company that qualified and properly elected to be taxed under Section 831(b).

76

- Feedback insured the Avrahamis' Arizona jewelry stores and shopping centers against **chemical and biological terrorist attacks.**
- The IRS believed that the microcaptive was organized for tax purposes and lacked insurance risk, and that risk was not shifted to the captive.

77

- There were no claims made on any of the Feedback policies until the IRS began an audit of the Avrahamis and their various entities' returns.

78

Judge Holmes: "While we recognize that Feedback is a microcaptive and must operate on a smaller scale than [those in other Tax Court cases], we can't find that it covered a sufficient number of **risk exposures to achieve risk distribution merely through its affiliated entities.**"

79

Summa Holdings, Inc.
v. Comm.,
(CA 6 2/16/2017)

8-12

Sixth Circuit Allows
Tax-Avoidance Use of
DISC

80

Background
on interest charge
domestic
international
sales
corporations
("IC-DISCs")

81

- An IC-DISC is a congressionally created entity designed to subsidize exporters.
- First, the exporting entity (C, S, PSP, sole-prop.) creates a second corporation—the IC-DISC and files IRS Form 4876-A.

82

- The U.S. export company deducts “commission” payments to the DISC of up to 4% of gross receipts or 50% of net income from qualified exports.
- A DISC pays no tax on its commission income (but is deemed distributed if over \$10,000,000).

83

The DISC can:

- Retain the commissions and invest them or loan them back to the exporter; or
- Pay them out as qualified dividends to its shareholders.

84

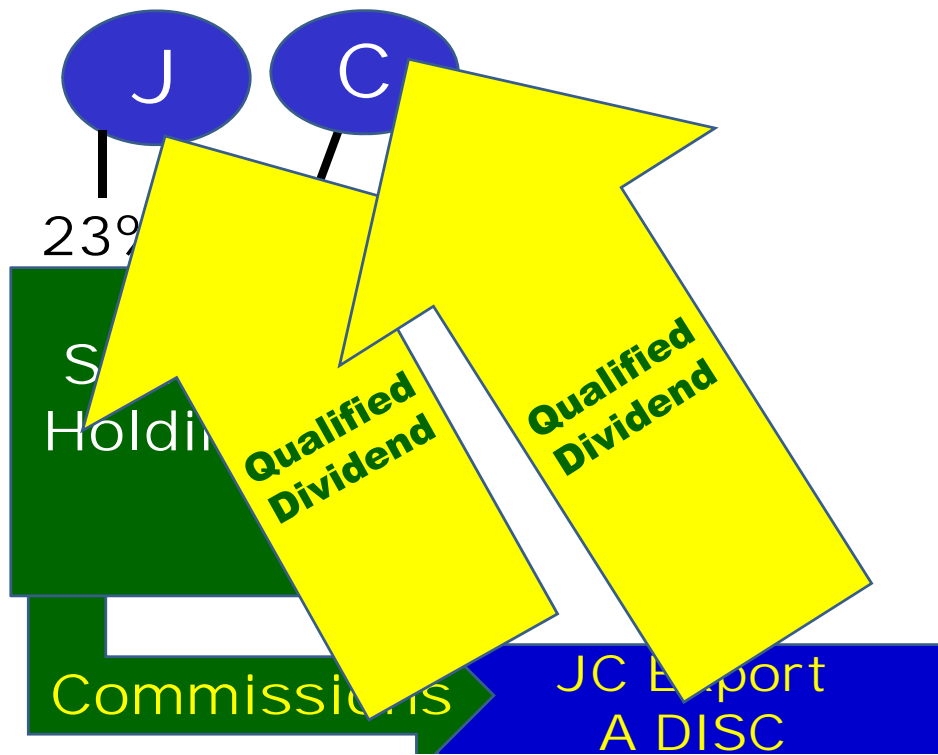
- DISC shareholders must pay annual interest on their shares of the deferred tax liability on commissions retained by the DISC (section 995(f)).

85

IRS IC-DISC Audit Guide:

“DISC is not concerned about performance of any activities and, therefore, does not need employees or office space and does not have to actually participate in the soliciting, negotiating or concluding of any sales contract or perform any economic functions to earn a commission.”

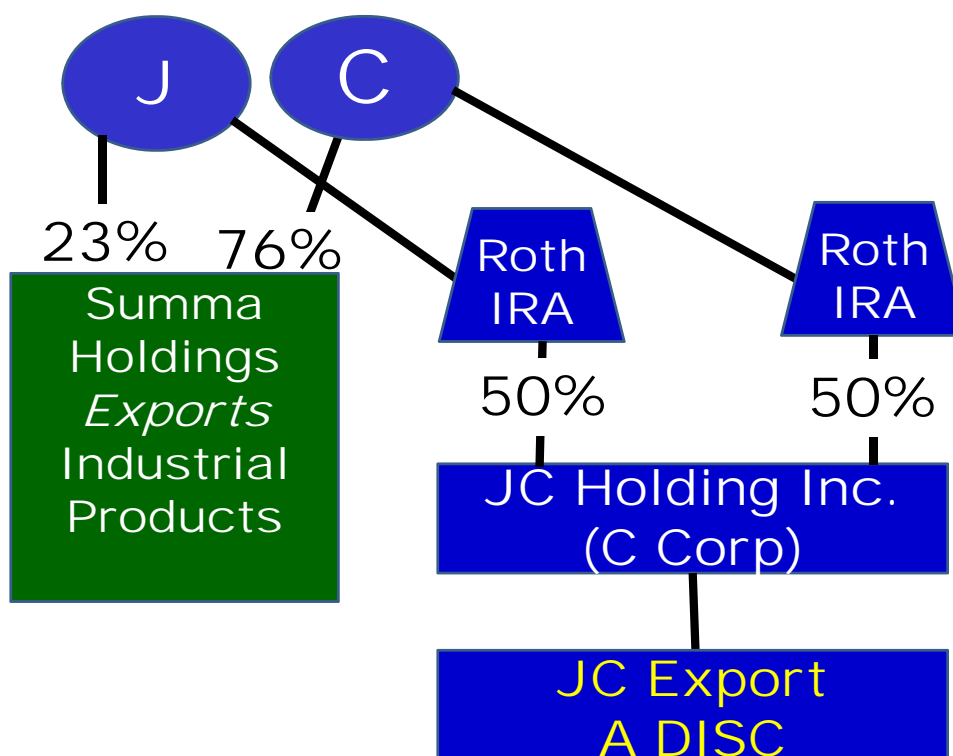
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Facts of Summa Holdings

"In 2001, [J and C] each established a Roth IRA and contributed \$3,500 apiece. Just weeks after [J and C] set up their accounts, each Roth IRA paid \$1,500 for 1,500 shares of stock in **JC Export, a newly formed DISC.**"

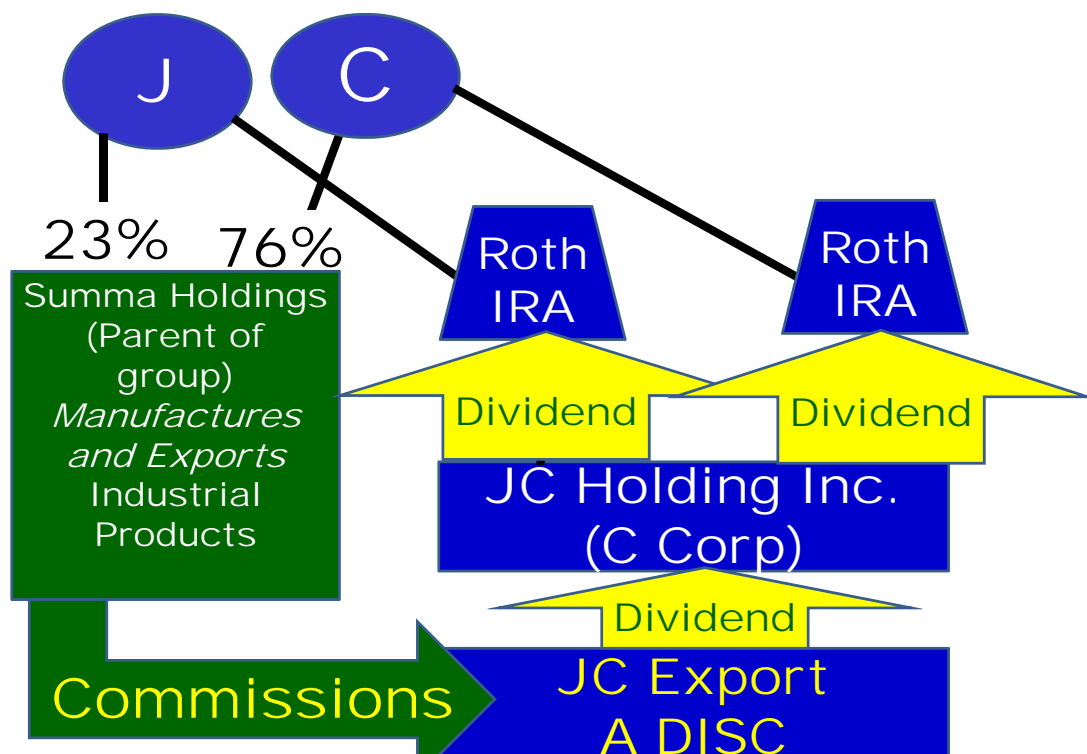
89



“The Commissioner did not challenge the valuation of these shares then **and has not challenged them since.**”

(likely a mistake by the IRS)

91



“JC Holding paid a 33% income tax on the dividends, then distributed the balance as a dividend to its shareholders [J and C’s] two Roth IRAs.”

93

“From 2002 to 2008, [J and C] transferred \$5,182,314 from Summa Holdings to the Roth IRAs in this way, including \$1,477,028 in 2008. By 2008, each Roth IRA had accumulated over \$3 million.”

94

Sixth Circuit Holding Reversing Tax Court

“By congressional design, DISCs are **all form and no substance**, making it inappropriate to tag Summa Holdings with a substance-over-form complaint [**the IRS and Tax Court view,**] with respect to its use of DISCs.”

95

“The same is true for the Roth IRAs. They, too, are designed for tax-reduction purposes. Whether Congress's decision to permit Roth IRAs to own DISCs was an oversight makes no difference. It's what the law **allowed. ******”

96

“The last thing the federal courts should be doing is rewarding Congress's creation of an intricate and complicated Internal Revenue Code by closing gaps in taxation whenever that complexity creates them.”

97

*Crestek, Inc. &
Subsidiaries*, 149 TC
No. 5 (July 27, 2017)

8-15

Transactions With Foreign
Affiliates Trigger CFC U.S.
Property Rule for U.S.
Parent

98

Eaton Corporation and Subs, TC Memo 2017-147 (July 26, 2017)

8-16

IRS's Cancellation Of Advance Pricing Agreements Was Abuse Of Discretion

99

Starr International Company, Inc. V. U.S., (DC DC 8/14/2017)

8-17

Corporation Denied Discretionary U.S.-Swiss Treaty benefits and was "Treaty Shopping"

100

District Holding For IRS

“Starr's legalistic conception of 'treaty shopping,' ... cannot be squared with the text of the U.S.-Swiss treaty or its accompanying agency guidance.”

101

Instead, those authorities understand "treaty shopping" as encompassing situations where an entity establishes itself in a treaty jurisdiction with a "principal purpose" of obtaining treaty benefits.

102

Because the IRS reasonably applied that standard in denying treaty benefits to Starr, the Court declines to set aside its determination.

103

IRS IPU on Exchange Gains/Losses on Payables and Receivables Denominated in a Nonfunctional Currency (1/30/2017)

8-18

104

*Amazon.com, Inc &
Subsidiaries, 148 TC
No. 8 (3/23/2017)*

8-19

Amazon Wins Big In
Cost-Sharing Dispute

105

Facts

As consideration for the transfer of pre-existing intangibles, Amazon's Luxembourg Subsidiary made a \$254.5 million buy-in payment to Amazon.

106

IRS said the
buy-in payment
should be \$3.468
billion (instead of
254.5 million).

107

Tax Court Holdings:

- 1) [IRS's] determination
with respect to the
buy-in payment is
arbitrary, capricious,
and unreasonable.

108

2) Amazon's comparable uncontrolled transaction (CUT) method ... "is the **best method** to determine the requisite buy-in payment."

109

3) IRS "**abused his discretion** in determining that **100% of Technology and Content** costs constitute [intangible development costs (IDCs)]."

110

4) Amazon's "cost-allocation method, with certain adjustments, **supplies a reasonable basis for allocating costs to IDCs.**"

111

Ann. 2017-3
(March 27, 2017)

8-20

IRS Report On 2016
Advance Pricing
Agreements

112

*Congressional Budget
Office, International
Comparisons of Corporate
Income Tax Rates
(March 2017)*

8-20

CBO updates report comparing
U.S. corporate income tax rate
to other G20 countries

113

*IRS International
Practice Units
Training Aids*

8-21

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