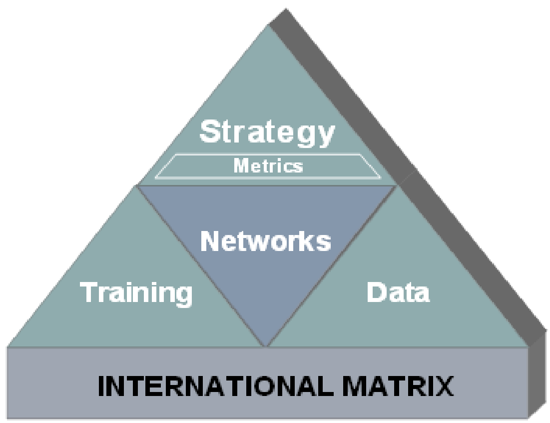
International Technical Training



Instructor Guide

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IRS

Department of the Treasury
Internal Revenue Service

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Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

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The Employee Numbers, Computer ID Numbers, Social Security Numbers (SSNs) and any other identification used in this course are hypothetical. They were constructed by random selection of numbers to appear realistic and increase the effectiveness of the training. Any duplication of numbers actually assigned is purely coincidental. All other names and numbers used in this material are fictitious.

Naming Conventions

Any taxpayer and business names shown in this publication are fictitious. They were chosen at random from a list of names of Counties and Colleges in the United States as shown in *United States Government Printing Office Style Manual*. Street addresses were chosen from this same list, and are also not meant to identify any actual addresses.

Graphics and Screen Captures

This Guide contains numerous exhibits of screen captures. These screens do not contain any live taxpayer information. Where possible, the captures are from the training database.

IRM Revisions

Each Lesson should be checked carefully and IRM references updated, if needed.

During preparation and instruction, **instructors should ensure all IRM references are current.** The SERP homepage should be used to obtain IRM updates.

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International Technical Training

Chapter 1

Source of Income

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide
Participant References	• Handout 1A – Rev. Rul. 79-389 • Handout 1-B – Rev. Rul. 89-67, 1989-1 CB 233 • Handout 1-C – Summary of Source Rules
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides • Flipcharts and markers

Overview

Instructor Notes

This chapter introduces the topic of income sourcing and will discuss the provisions governing the sourcing of income. It is the most important lesson we will cover in this program because it serves as a building block for the entire course.

Introduction

This chapter is basic to the entire foreign issues course. Once you are able to determine the source of the various types of income that a taxpayer might receive, you will be able to comprehend the subsequent lessons more easily.

U.S. citizens and resident aliens are taxed by the U.S. on their worldwide income, no matter where it originates. What, then, is the importance of the sourcing of income if all income is taxable? For taxpayers who qualify for the exclusion of income earned abroad, the source of income is very important because only income from sources outside the U.S. may qualify to be excluded from taxation under IRC § 911. It is also important for those taxpayers who wish to claim a foreign tax credit, since the credit is calculated on the basis of foreign income.

The following chapter will discuss the provisions governing the sourcing of income. It is the most important chapter we will cover in this training because it serves as a building block for the entire course. The exclusion of income earned abroad and foreign tax credit will be covered in detail in later chapters.

Objective

At the end of this chapter, the student will be able to determine whether income is foreign source or U.S. source.

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Contents

This chapter contains the following topics:

Continued on next page

Instructor Notes

May use a PowerPoint presentation to present this chapter.

☑ When the Internal Revenue Code (IRC) speaks of sourcing of income, it is referring to the origin of the income as being earned in the U.S. or in a foreign country.

Definition

☑ **<u>U.S.-source income:</u>** income determined by tax law to be from within the U.S.

☑ **<u>Foreign-source income:</u>** income determined by tax law to be earned outside the U.S.

United States

U.S., when used in a geographical sense, includes 50 states and the District of Columbia. It also includes the territorial waters of the U.S. and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the U.S. and over which the U.S. has exclusive right, in accordance with international law, with respect to the exploration and exploitation of natural resources. It does not include the possessions and territories of the U.S. or the airspace over the U.S. **(Treas. Reg. §301.7701(b)-1(c)(2)(ii)).**

Foreign Country

Foreign Country, when used in a geographical sense, includes any territory under the sovereignty of the United Nations or a government other than that of the U.S. **(Treas. Reg. §301.7701(b)-2(b)).**

Foreign Source Income

Introduction

Key Points:

- U.S. citizens and resident aliens are taxed by the U.S. on their worldwide income, no matter where it originates. What, then, is the importance of the sourcing of income if all income is taxable? For taxpayers who qualify for the exclusion of income earned abroad, the source of income is very important because only income from sources outside the U.S. may qualify to be excluded from taxation under IRC § 911. It is also important for those taxpayers who wish to claim a foreign tax credit, since the credit is calculated on the basis of foreign income.
- The exclusion of income earned abroad and foreign tax credit will be covered in detail in later lessons.
- This lesson is basic to the entire foreign issues course. Once you are able to determine the source of the various types of income that a taxpayer might receive, you will be able to comprehend the subsequent lessons more easily.

Interest

Reading Assignment

Read IRC §§ 861(a)(1) and 862(a)(1).

Interest that arises from sources within the 50 states and the District of Columbia is income from sources within the U.S. Interest income includes earnings from bank accounts, bonds, and notes. Interest income also includes earnings on obligations of domestic corporations and non-corporate residents such as individuals. It is the **residence of the payer** that determines the source of interest income. If the payer is located in the U.S., the interest is U.S. source.

Example 1

Michele, a resident of New York, receives interest from a personal loan made to Francois, a U.S. citizen and resident of Paris. The key to the source of income is the **residence of the payer**. Since Francois is a resident of Paris, although a U.S. citizen, the income is foreign source.

Key Point:

- There are a few rare exceptions to this rule. These exceptions are found in IRC §§ 861(a)(1)(A) through (C).

Exercise 1

Gayle, a U.S. citizen, lives and works in Italy. All of her income is earned in Italy. She deposits some of her earnings in her bank in Boston, Massachusetts, where it earns interest. What is the source of her interest income? Explain.

Answer:

Dividends

Reading Assignment

Read IRC §§ 861(a)(2) and 862(a)(2).

Limitations

Key Point:

- IRC § 861(a)(2) provides that dividends from domestic corporations are U.S. source income. Dividends from foreign corporations are foreign source. Exceptions to this rule can be found in IRC § 861(a)(2) but the general rule remains the same.

Example 2

Jayne, a citizen of the Netherlands residing in the U.S., receives dividends from a corporation located in the Netherlands Antilles which are deposited into her U.S. bank account. Since the corporation is foreign, the dividends are foreign source.

Compensation for Personal Services

Reading Assignment

Read IRC §§ 861(a)(3) and 862(a)(3).

Compensation for labor or personal services is income from sources inside or outside the U.S., depending on where the labor or services are performed. Compensation includes wages, tips, salaries, and other employee compensation, as well as earnings from self-employment.

Example 3

Joe, a U.S. citizen residing in the U.S., is a consultant for a Japanese firm and works in its New York branch office. Joe's income is U.S. source because he is performing the services in New York.

If compensation for labor or personal services is earned both inside and outside the U.S., an allocation must be made under Treas. Reg. § 1.861-4(b). See Chapter 8 for a discussion on this.

Note: Partnership income retains its character where it flows through to the individuals' Form 1040. If 60% of the partnership income is foreign source, then 60% of the distribution is foreign source. This is true even if the partner only performs services in a foreign country.

Exercise 2

Harry, a U.S. citizen and employee of a U.S. corporation, is sent to France for one month on a temporary assignment. His employer continues to pay his regular salary in U.S. dollars and the checks are deposited in his U.S. bank. Does Harry have any foreign source income? Explain.

Transportation Income

Reading Assignment

Read IRC § 863(c).

Transportation income is income from the use of a vessel or aircraft or for the performance of services directly related to the use of any vessel or aircraft.

All income from transportation that begins **and** ends in the U.S. is treated as derived from sources in the U.S. If the transportation begins or ends in the U.S., 50% of the transportation income is treated as derived from sources in the U.S.

Note: Some treaties allocate income from the operation of international transportation to one treaty partner or the other.

Rents and Royalties

Reading Assignment

Read IRC §§ 861(a)(4) and 862(a)(4).

The **location of rental property** determines the source of the income. Rentals from property located in the U.S. are U.S. source. The same rule applies to natural resource royalties (oil, coal, etc.) because real property is involved.

Example 4

Phil, a U.S. citizen, owns a chalet in Switzerland. He rents the chalet to another American who wires the rent in U.S. dollars directly into Phil's U.S. bank account. The rental income is foreign source because the chalet is located in Switzerland.

Royalties paid for the use of, or for the privilege of using, **in the U.S.**, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property are U.S. source income. For these types of royalties, the source is determined by **where the property is used.**

Example 5

Sidney, a subject of the United Kingdom, makes films in Italy. He receives royalties wherever the films are shown. When his films are shown in the U.S., his royalties are U.S. source income.

Rents and royalties are both covered by IRC § 861(a)(4). The source of rents and natural resource royalties is where the property is located (where the rental building, the oil well, or the coal mine is physically situated). The source of royalties from patents, copyrights, etc., is where the property is used.

Continued on next page

Example 6

Duke, a U.S. citizen who lives in Ohio, receives royalties from Canada Natural Gas Unlimited. The gas is piped from Canada to the U.S. for use in Ohio. The royalties are natural resource royalties and the resource is located in Canada. In this case, the source is where the property (the natural gas fields) is located rather than where the natural gas is used.

Sale or Exchange of Real Property

Reading Assignment

Read IRC §§ 861(a)(5) and 862(a)(5).

Gains, profits, and income from the sale or exchange of real property located in the U.S. are U.S. sourced. It is the **location** of the real property which determines the source of the income when the property is sold.

Sale or Exchange of Inventory Property

Reading Assignment

Read IRC §§ 861(a)(6), 862(a)(6), and 865.

Income from sales of inventory property (property that is stock in trade or primarily held for sale to customers) is sourced **where the sale takes place.**

Income from the sale of most other personal property is sourced in the U.S. if the seller is a U.S. resident, and sourced outside the U.S. if the seller is a nonresident. For this purpose, § 865(g) defines a U.S. resident as any individual who has a tax home in the U.S.

If a U.S. citizen or resident alien pays foreign income tax equal to 10% of the gain from the sale of personal property, that individual will be treated as a nonresident of the U.S. for purposes of the sourcing rules in IRC § 865.

Reading Assignment

See IRC §§ 865(c), (d), (e), and (f) for exceptions to the source rules for sale of personal property.

Pensions and Social Security Benefits

In most cases, the source of a pension is important only when the taxpayer has resided overseas during some portion of his or her working career. Based on what you have learned so far, why is this so? Rules for determining the source of a pension paid from current operating funds (a rare instance) are discussed in Rev. Rul. 55-294. To determine the source of a pension from a pre-funded plan (the more common case), refer to Rev. Rul. 79-389 (Handout 1-A). Social Security benefits are considered to be U.S. source per IRC § 861(a)(8).

Scholarships, Fellowships, Grants, Prizes and Awards

Generally, the source of scholarships, fellowship grants, grants, prizes, and awards is the residence of the **payer** regardless of who actually disburses the funds.

Reading Assignment

Read Rev. Rul. 89-67 (Handout 1-B).

Example 7

John, a U.S. citizen residing in the U.S., receives a Fulbright grant to perform research in Cairo, Egypt. Because the payer is the U.S. government, the fellowship is considered U.S. source. If the grant was received from the University of Egypt, it would be foreign source.

Effect of Treaties on Sourcing

Income tax treaties between the U.S. and foreign countries contain special sourcing provisions that take precedence over the sourcing provisions of the Internal Revenue Code.

Summary

1. The income sourcing rules determine which income is taxable to a foreign person and which income qualifies for the foreign tax credit and the foreign earned income exclusion of U.S. persons.
2. Handout 1-C summarizes the sourcing provisions by income type.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

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Class Exercises

Exercise 1

Note: Handout 1-C may be used as a guide.

Indicate whether the following items of income would be considered U.S. source or foreign source income.

a. Fred, a U.S. citizen residing in Canada, sold his sailboat in Canada to Alice, a U.S. citizen.

Answer: The income would be U.S. source unless Fred had paid at least 10% Canadian tax on the gain. IRC § 865(g)(2).

b. Rental income from a rental apartment in Paris is owned by a U.S. citizen. The rental income is remitted directly to the owner's U.S. bank account.

Answer: Foreign – sourcing is based location of property

c. Wages paid to a U.S. citizen who works in Germany for a U.S. corporation.

Answer: Foreign – where service is performed

d. Wages earned by the taxpayer in c. above, while attending a three-day business convention in New York as a representative for his employer.

Answer: U.S. – where service is performed

Continued on next page

Exercise 1 (continued)

e. Sale of a vacant lot in Australia. The sale took place in San Francisco.

Answer: Foreign – location of property

f. Choo, a Japanese citizen and resident, received a scholarship from the University of Maryland for his studies at the university. Is the scholarship U.S. or foreign source?

Answer: U.S. – the scholarship is from the University of Maryland

Exercise 2

Answer the questions and cite the relevant IRC section.

1. Mr. Zapata is an U.S. citizen and employee of an U.S. corporation (Butterball turkey) in Turkey. He is sent to the U.S. for 1 month of training. His employer continues to pay his regular salary in U.S. dollars and the checks are deposited in his U.S. bank. Does Mr. Zapata have any foreign source income?

   Answer:

2. Traci lives and works in Indonesia for the Jakarta Express. All of her income is earned there, but she does deposit some of it in her bank in Boston, MA, where it earns interest. What is the source of her interest income? Explain.

   Answer:

3. Tom, a U.S. citizen residing in Brazil, receives dividends from the Brazilian Nut Corp. (a Brazilian corp.) which are deposited in his Brazilian bank account. Is this income U.S. or foreign source?

   Answer:

Continued on next page

Exercise 2 (continued)

4. Tom, from Question 3, owns an apartment building in Brazil from which he receives rent. Is the income U.S. or foreign source, and why?

   Answer:

5. Heidi, a citizen of Switzerland, owns a patent on a wool-processing machine she invented. The machine has been used all over the world. However, now it is being used in Montana. Heidi is receiving $10,000 in royalties for its use in Montana. Is the income U.S. or foreign source?

   Answer:

6. Sue Ellen, a U.S. citizen living in London, England, receives royalties from a West Virginia coal mine in which she has a one-eighth ownership interest. Is the income U.S. or foreign source?

   Answer:

7. Joan, a U.S. citizen residing in the U.S., owns a piece of land in Switzerland. She sells the land while residing in the U.S. to a Swiss Guard who lives and works in the Vatican. Is the income U.S. or foreign source?

   Answer:

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Exercise 2
(continued)

8. Frank, a U.S. citizen residing in France, goes to Burkina Faso to sell his car to an Eritrean visitor, for a 50% profit over the original cost. A bank in Burkina Faso handled the sale. Frank was not subject to tax in France or Burkina Faso on this income. Is the income U.S. or foreign source?

   Answer:

9. John Nguyan, a citizen and resident of Viet Nam, is receiving one scholarship from MIT and one from the University of Hanoi. He is attending MIT. Is the income U.S. or foreign source?

   Answer:

10. Miss Peach, a movie actress, made several movies in California. Her movies are shown worldwide. Does she have U.S. or foreign income?

    Answer:

Handout 1-A – *Rev. Rul. 79-389*

Issue

What is the proper method of computing the portion of a pension payment that is income from sources without the U.S. for purposes of determining the limitation on the credit for foreign taxes pursuant to § 904 of the Internal Revenue Code?

Facts

The taxpayer, a citizen of the U.S., was employed in the U.S. for a period of years by a U.S. employer and was employed abroad on behalf of this employer continuously from January 1, 1965 through December 21, 1977, when the taxpayer retired and became eligible for a pension. During the taxpayer's employment, the employer, on behalf of the taxpayer, contributed to a qualified pension trust described in § 401(a) that is exempt from tax under § 501(a). The pension plan is a noncontributory arrangement with respect to employees. The pension plan invested the contributions and received income from the investments.

The taxpayer files a Federal income tax return on a calendar year basis. Since January 1, 1978, the taxpayer's first day of retirement, the taxpayer has resided abroad in foreign country X. Country X imposed an income tax on the pension income that the taxpayer received in 1978.

Law and Analysis

Section 901 (b)(1) of the Code provides that, subject to the limitation of § 904, a citizen of the U.S. shall be allocated as a credit under § 901(a) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the U.S.

Section 904(a) of the Code provides that the total amount of the credit taken under § 901(a) shall not exceed the same proportion of the tax against which such credit is taken that the taxpayer's taxable income from sources without the U.S. (but not in excess of the taxpayer's entire taxable income) bears to the taxpayer's entire taxable income for the same taxable year.

Continued on next page

Law and Analysis (continued)

Sections 861 through 864 of the Code contain rules for sourcing income for services performed within and without the U.S., but those sections contain no specific provision regarding the source of income from pensions.

Section 861(a)(3) of the Code provides that compensation for labor or personal services performed in the U.S. shall be treated as income from sources within the U.S. and § 862(a)(3) provides that compensation for labor or personal services performed without the U.S. shall be treated as income from sources without the U.S.

Section 1.861-4(b)(1) of the Income Tax Regulations provides, with respect to taxable years beginning after December 31, 1975, that when labor or service is performed partly within and partly without the U.S., the amount to be included in the gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

Employer contributions to an annuity or pension plan represent compensation for personal services. See Rev. Rul. 56-82, 1956-1 C.B. 59. An employer's contributions to a pension plan with respect to wages earned abroad by a taxpayer are compensation for labor or personal services performed without the U.S. and are treated as derived from sources without the U.S.
See Rev. Ruling. 72-149, 1972-1 C.B. 218.

Rev. Rul. 56-125, 1956-1 C.B. 627, indicates that distributions to a citizen of the U.S. from a qualified pension trust are income from sources within the U.S., to the extent such distribution represent earnings and accretions to contributions of either the employer or the employee.

Continued on next page

Holding

In determining the proper allocation between U.S. and foreign sources of the distributions from the U.S. plan for purposes of computing the limitation on the credit for foreign taxes under § 904(a) of the Code, that part of the distribution that represents the earnings of a U.S. pension plan is income from sources within the U.S. and the taxpayer's taxable income from sources without the U.S. includes only the amount of the pension distribution attributable to the employer's contributions to the pension plan with respect to wages earned abroad by the taxpayer. Therefore, that portion of the pension payment that is income from sources without the U.S. for purposes of determining the limitation on the credit for foreign taxes pursuant to § 904(a) is determined by multiplying the portion of the pension payment received by the taxpayer that is attributable to the employer's contributions with respect to wages by the ratio that the employer's contributions made to the pension plan with respect to wages earned by the taxpayer while the taxpayer was employed outside of the U.S. bears to the total of the employer's contributions to the pension plan with respect to all the wages earned by the taxpayer.

The principles of this Revenue Ruling are illustrated by the following example:

> *A*, a citizen of the U.S. residing abroad, received payments from a U.S. pension plan totaling 15x dollars for the taxable year. The portion of the 15x dollars attributable to earnings of the pension plan is 5x dollars, and the portion attributable to employer contributions is 10x dollars. *A*'s employer contributed a total of 100x dollars to the pension plan with respect to wages earned by *A*. 20x dollars of this amount was contributed to the plan by the employer while *A* was employed outside of the U.S. The portion of the pension received during the taxable year that was income from sources without the U.S. for purposes of determining the limitation on the credit for foreign taxes paid by *A* pursuant to § 904(a) is 2x dollars *(10x × 20x).*

For a related issue involving pension payments to a nonresident alien, see Rev. Rul. 79-388, page 270, this bulletin.

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Handout 1-B – *Rev. Rul. 89-67, 1989-1 CB 233*

Issue

What is the source of an amount paid as a fellowship or a scholarship?

Law and Analysis

Section 863(a) of the Internal Revenue Code of 1986 provides authority for the Commissioner to allocate or apportion items of gross income not specified in §§ 861 and 862 to sources within and without the U.S. No statutory rule is provided under § 861 or 862 for income received to support or subsidize a recipient's research or study activities.

Rev. Rul. 66-292, 1966-2 C.B. 280, held that the source of an amount received as a scholarship or fellowship is determined by where the research or study activities take place. A companion ruling, Rev. Rul. 66-291, 1966-2 C.B. 279, held that the source of an award for a puzzle contest is determined by where the activities required to solve the puzzle are performed. The rules contained in these revenue rulings are analogous to the rule contained in §§ 861(a)(3) and 862(a)(3) of the Code that sources compensation from personal services where the services are performed. There is no indication in either cited revenue ruling, however, that the recipients performed any services for the payor, and Rev. Rul. 66-292 explicitly states to the contrary. (See also Rev. Rul. 80-98, 1980-1 C.B. 368, and Rev. Rul. 61-65, 1961-1 C.B. 17, where receipt of fellowship awards similar to the awards under consideration in Rev. Rul. 66-292 are treated as not involving compensation for personal services.) The amount received to support or subsidize research and study and the amount received in respect of puzzle-solving activities described in the two revenue rulings is not compensation for personal services because no services are performed. Absent a significant economic nexus with the place where the study and research and puzzle-solving activities are performed, it is more appropriate to source these payments where the principal economic nexus exists, namely, at the residence of the payor. Thus, for example, scholarship or fellowship payments for research or study, and amounts paid for puzzle-solving activities, made by the U.S. or a political subdivision thereof, a noncorporate U.S. resident, or a domestic corporation will be from U.S. sources. Similar payments by a foreign government or a foreign corporation will be foreign source payments.

Continued on next page

Law and Analysis (continued)

Payments made by an entity designated as a public international organization under the International Organizations Immunities Act (see § 7701(a)(18)) will be foreign source payments.

Law and Analysis (continued)

The fact that payments are made by intermediary agency acting on behalf of the payer does not alter this result, provided that a genuine agency relationship exists.
(Compare Rev. Rul. 54-483, 1954-2 C.B. 168, where amounts paid by the U.S. Government, acting as an agent of a contractor rendering services abroad for the government, to U.S. citizen employees of the contractor directly pursuant to contract are not amounts paid by the U.S).

Holding

The source of a payment made as a scholarship, fellowship, or an award for puzzle-solving contest activities is the residence of the payor.

Effect on Other Revenue Rulings

Rev. Rul. 66-291 and Rev. Rul. 66-292 are revoked.

Effective Date

The effective date of this revenue ruling is May 15, 1989. Taxpayers may apply the ruling retroactively to amounts received on or after January 1, 1986.

Drafting Information

The principal author of this revenue ruling is Carol P. Tello, Office of the Associate Chief Counsel (International). For further information on the ruling, call Ms. Tello on (202) 377-9059.

Handout 1-C – *Summary of Source Rules*

Income	Source	Citation
Salaries, wages and other compensation	Where services are performed	IRC § 861(a)(3) IRC § 862(a)(3)
Interest	Residence of payer	IRC § 861(a)(1) IRC § 862(a)(1)
Dividends	Where corporation is incorporated	IRC § 861(a)(2) IRC § 862(a)(2)
Rents (real property and natural resource royalties, i.e., oil/gas)	Where property is located	IRC § 861(a)(4) IRC § 862(a)(4)
Royalties (non-natural resources), i.e., patents, copyrights, secret processes, formulas, goodwill, trademarks, trade brands, franchises	Where the property is used	IRC § 861(a)(4) IRC § 862(a)(4)
Sale/exchange real property	Where property is located	IRC § 861(a)(5) IRC § 862(a)(5)
Sale/exchange personal property **Exception:** U.S. citizens/resident aliens with tax home outside U.S.	Where seller's residence is located – U.S. source unless tax of at least 10% of the gain from the sale is paid to a foreign country	IRC § 865(a) IRC § 865(g)(2)

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Income	Source	Citation
Exceptions for Types of Property		
Depreciable property	• U.S. source to the extent previous deductions for depreciation were allocable to U.S. source income. • Foreign source to the extent previous deductions for depreciation were allocable to foreign source income (gain in excess of the depreciation adjustments is sourced the same as inventory property, where the title passes).	IRC § 865(c)
Inventory property	Where title passes	IRC §§ 865(b), 861(a)(6), 862(a)(6) and 863(b)
Intangibles	Same as royalties, where property is used	IRC § 865(d)
Pensions	Where services were performed that earned the pension	Rev. Rul. 55-294
Sale/exchange personal property	• Sale through office or fixed place of business outside of U.S. is foreign source if income attributable to business operations located outside the U.S. and tax of at least 10% of the income from the sale is paid to the foreign country.	IRC § 865(e)
Social Security benefits	U.S. source	IRC § 861(a)(8)
Scholarships/ Fellowships	Residence of payer	Rev. Rul. 89-67
* The rules under "Personal Property Sales After 1986" apply to foreign persons **for transactions entered into after March 18, 1986**.		

International Technical Training

Chapter 2

Alien Status

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 2 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk
Participant References	• Handout 3-A • Forms 8833, 8840, and 8843
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by Instructor) • Flipcharts and markers

Overview

Introduction

This chapter provides the necessary information to determine the status of aliens. Resident aliens, nonresident aliens, and a third category, dual-status aliens, are all taxed differently. Determining the correct alien status is extremely important. Once you know the correct status, the computation of tax is easy.

This lesson only addresses determining the correct status. Subsequent lessons include chapters on taxation of nonresident, resident, and dual-status aliens, international organizations and tax treaties.

Objective

At the end of this lesson, the student will be able to determine the status of:

- Nonresident Aliens
- Resident Aliens
- Dual-Status Aliens

Contents

This lesson covers the following topics:

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Contents
(continued)

Definitions

Instructor Notes

Go through the definitions and stress that these terms will be used throughout this training.

Reading Assignment

Treas. Reg. § 1.871-13(a) (1).

- **Bona fide resident** is an individual who meets a time requirement (entire tax year) and certain other factors that indicate "permanent" residence in a country or possession.
- A **resident alien** is an individual who is not a U.S. citizen, but who meets either the “green card” test or the substantial presence test.
- A **nonresident alien** is an individual who is neither a U.S. citizen nor a resident of the U.S.
- A **dual-status alien** is an individual who changes status during the tax year either from nonresident to resident or from resident to nonresident.
- **Effectively connected income** is income, other than certain investment income, earned from sources within the United States while engaged in a U.S. trade or business.
- A **green card** is an alien registration card – Form 551, *Permanent Resident Card (or Form 151, Alien Registration Receipt Card).*
- A **lawful permanent resident** is one who has been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws; a green card holder.
- **Not effectively connected income** is income that does not meet the criteria to be effectively connected.

Types of Aliens

Reading Assignment

Treas. Regs. §§ 301.7701(b)-1(a) and 301.7701(b)-1(c).

☑ U.S. citizens generally are those people who are born in the U.S., born abroad of U.S. parents, or naturalized as citizens by a court proceeding. All others are aliens. The three categories of aliens are:

- Resident Aliens
- Nonresident Aliens
- Dual-status Aliens

Determining Resident Alien Status

There are two tests used to determine resident alien status:

- The “green card” test, and
- The substantial presence test.

In addition, an alien may make an election to be treated as a resident in his first year in the United States.

Green Card Test

Reading Assignment

Read IRC § 7701(b) (1) (A) (i).

Green Card Test

Key Points

- An alien, who has an immigrant visa, or “green card”, is a resident alien. A “green card” is issued by Homeland Security and lawfully grants the alien the privilege of residing permanently in the U.S.
- A Lawful Permanent Resident (LPR), also known as a “green card holder”, maintains his status until there is a final administrative or judicial determination that the green card has been revoked or abandoned or that the LPR becomes a U.S. citizen. Might add or until he comes a U.S. citizen.
- LPRs may surrender their status by completing Form I-407. USCIS (formerly INS) signs and returns the form; this is the LPR’s official notice of the administrative determination. Cutting up the card or not entering the U.S. for long periods of time does not change taxpayer’s status from LPR to nonresident.

Substantial Presence Test

Reading Assignment

IRC §§ 7701(b) (1) (A) (ii) and 7701(b) (3) (A).

An alien who meets the substantial presence test is a resident alien. An individual meets this test if he has been present in the U.S. for at least 183 days during a 3-year period that includes the current year. The 183 days must include at least 31 days in the current year.

Compute total days of presence by counting:

- the days of physical presence in the current year, and
- 1/3 of the days of presence in the first preceding year, and
- 1/6 of the days of presence in the second preceding year.

Example 1

David was physically present in the U.S. for 120 days in each of the years 2006, 2007, and 2008. In determining whether he meets the substantial presence test for 2008, he counts the full 120 days of presence in 2008, 40 days in 2007 (1/3 of 120) and 20 days in 2006 (1/6 of 120).

Since the total for the 3-year period is 180 days, David is not treated as a resident alien under the substantial presence test for 2008.

Example 2

Sean entered the United States on March 4, 2008, and left on November 3 of the same year. He was present in the U.S. for 243 days in 2008.

Therefore, he has met the substantial presence test and is treated as a resident alien.

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Example 3

Yuri was physically present in the U.S. for 150 days in 2006, 30 days in 2007, and 160 days in 2008. His calculation for the substantial presence test is:

2008 (all days)	160 days
2007 (1/3 of 30)	10 days
2006 (1/6 of 150	-25 days
	195 days

Yuri has met the substantial presence test for 2008 and is treated as a resident alien for tax purposes in 2008.

For purposes of the substantial presence test, a day of presence is any day that an alien is physically present in the U.S. at any time during that day.

In determining substantial presence, the term “United States” does not include Insular Areas, U.S. territories, or air space.

To determine alien status of individuals in the Insular Areas or U.S. territories, there are additional factors to be considered.
See Treas. Regs. § 301.7701(b)-1(d) for further information.

Exercises

Exercise 1

Juan, a citizen of Spain, entered the U.S. on September 1, 2006, with an H-1B visa. He departed the country on May 31, 2008. Does he meet the substantial presence test for 2006? 2007? 2008? State the reason for your answer.

a. 2006

Answer: No. Juan was in the U.S. only 122 days in 2006 and does not meet the substantial presence test.

b. 2007

Answer: Yes. Juan was in the U.S. 365 days in 2007, and 122 days in 2006 (365 in 2007 and 1/3 of 122 days in 2006 = 487 days). It is more than the required 183 days. He meets the substantial presence test.

c. 2008

Answer: Yes. Juan was in the U.S. 151 days in 2008, plus 1/3 of prior year (2007) days of 365 = 122 days, plus 1/6 of second prior year (2006) of 122 = 20 days. 151 days + 122 days + 20 days = 293 days.

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Exercise 2

Lee entered the United States on April 24, 2006, and left on January 25, 2008. He was in the country on a non-immigrant visa. Does he meet the substantial presence test for 2006? 2007? 2008? State the reason for each answer.

a. 2006

Answer: Yes. Lee entered the U.S. on April 24, 2006 and stayed in the U.S. for the rest of year. Total days in the U.S. were 255 days and he meets the substantial presence test.

b. 2007

Answer: Yes. Lee was in the U.S. 365 days in 2007, and 255 days in 2006 (365 in 2007 and 1/3 of 255 days in 2006 = 450 days). It is more than the required 183 days. He meets the substantial presence test.

c. 2008

Answer: No. Lee was only 25 days in the U.S. in 2008. He does not meet the substantial presence test.

Exempt Individual

Days for which an alien is an exempt individual do not count for the substantial presence test. An exempt individual is any alien in the following categories:

1. An individual temporarily present in the U.S. because of (a) diplomatic status, or a visa that represents full-time diplomatic or consular status; (b) full-time employment with an international organization; or (c) membership in the immediate family of a person described in (a) or (b).
2. A teacher or trainee, temporarily present in the U.S. under a “J” or “Q” visa (other than as a student), who substantially complies with the requirements of the visa.

   An alien will not be exempt under this category for a calendar year if he was exempt as a teacher or trainee or as a student for any 2 calendar years during the preceding 6 calendar years.

   If a foreign employer paid all his compensation for the period he was temporarily present in the U.S. under an “F” or “J” visa, he will not be exempt under this category if he was exempt as a teacher or trainee or as a student for 4 calendar years during the preceding 6 calendar years. For this purpose, a foreign employer includes an office or place of business maintained in a foreign country or Insular Area by an American entity.

3. A student temporarily present in the United States under an “F”, “J”, “M”, or “Q” visa, who substantially complies with the requirements of the visa.

   An alien will not be exempt as a student for any calendar year after the fifth calendar year for which he was exempt as a student or as a teacher or trainee, unless he can establish to the satisfaction of the Internal Revenue Service that he has complied with the terms of the student visa and does not intend to permanently reside in the U.S.

4. A professional athlete temporarily in the U.S. after October 22, 1986 to compete in charitable sports events.

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Definitions of the terms “foreign government-related individual”, “international organization”, “full-time diplomatic or consular status”, “teacher trainee”, “student”, “professional athlete” and “substantial compliance” can be found in Treas. Regs. § 301.7701(b)-3(b).

Reading Assignment

- IRC §§ 7701(b) (3) (D) (ii) and 7701(b) (7).
- IRC §§ 7701(b) (3) and (c).

Those qualifying to exclude days of presence are teachers, students, professional athletes, and individuals with a medical condition or problem.

If an alien is claiming an exclusion of days present in the U.S. for purposes of substantial presence test, he must file Form 8843 by attaching it to the timely filed (including extensions) tax return or, if taxpayer does not have a filing requirement, sending it the Austin Service Center by the due date, including extensions, of the 1040NR.

Closer Connection Exception to Physical Presence

Reading Assignment

Treas. Regs. § 301.7701(b)-2.

An alien who otherwise would meet the substantial presence test is not considered a resident alien for the tax year if the following three conditions are met:

1. Is present in the U.S. less than 183 days in the current year,
2. Maintains a tax home in a foreign country during the current year, and
3. Has a closer connection to the foreign country in which he has a tax home than he does to the U.S.

An alien's tax home is located at his regular or principal place of business or his regular place of abode. His tax home for the entire year must be in the foreign country to which he claims to have a closer connection.

An alien has a closer connection to a foreign country if he shows he has more significant contacts with the foreign country. Among the facts and circumstances to be considered are:

1. The location of his permanent home (this home must be available to him at all times, but may be owned or rented);
2. The location of his family;
3. The location of his automobile, furniture, clothing, and jewelry;
4. The location of social, political, cultural, or religious organizations to which he belongs;

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5. The location of his personal bank accounts;
6. The type of driver's license he has;
7. The country of residence he uses on forms and documents,
8. Where he is registered to vote; and
9. The types of official forms and documents he files (i.e., Form 1078, *Certificate of Alien Claiming Residence in the United States, or Form W 9, Request for Taxpayer Identification Number and Certification*).

If the alien takes action at any time to become a permanent U.S. resident, he is not eligible for the closer connection exception. Some of these actions are listed in Treas. Reg. § 301.7701(b)-2(f). Read this section.

Definitions of the terms medical condition, days in transit, and regular commuter from Canada and Mexico can be found in Treas. Reg. § 301.7701(b)-3(c), (d) and (e).

Example 4

Alex, a resident of Canada, has been working and living in the United States 5 months each year for the past 3 years. His American employer pays his salary. Alex votes in Canada where he and his family have a permanent home. Alex maintains his bank accounts, driver's license, and community ties in Canada. Alex is a nonresident alien, even though he meets the substantial presence test.

To claim a closer connection to a foreign country, an alien must timely file Form 8840 by attaching it to the timely filed (including extensions) tax return or, if taxpayer does not have a filing requirement, sending it the Austin Service Center by the due date, including extensions, of the 1040NR.

Residency Starting Date

Reading Assignment

IRC § 7701(b) (2) (A), § 7701(b) (2) (C) (ii) and Treas. Reg. § 301.7701(b)-4(c).

In the first year of residency, an alien will be considered a resident only for the portion of the calendar year that begins with the residency starting date.

The residency starting date for a “green card” holder is the first day he is present in the U.S. with a “green card”.

For an alien meeting the substantial presence test, the residency starting date is his first day of presence in the U.S. Rules relating to de minimis presence in computing the substantial presence test are found in Treas. Reg. § 301.7701(b)-4(c).

Exercise 3

Betsy Nasson, a citizen of France, was granted a valid green card on January 1, 2008 but spent all of January through October 19, 2008, sunning herself on the French Riviera. She flew to New York on the evening of October 19th, arriving the next morning. What is Betsy’s residency starting date?

Answer: October 20, 2008 – the first day present in the U.S. while a lawful permanent resident.

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Example 5

Lincoln Viterbo came to the United States from Venezuela on March 4, 2008. He had never been in the United States before this and wasn't sure if he would like living here. Rather than "burn his bridges", he took a leave of absence from his job in Venezuela and kept his apartment there. While looking around, he was so happy here that on April 20, 2008 he called his employer in Venezuela, resigned from his job, and gave up his apartment after speaking to his landlord. He stayed in the United States all of 2009 and would like to live here permanently.

Lincoln's residency starting date is either March 4 or March 14. He qualifies for a March 4 date, which was his first day of physical presence in the United States as he meets the substantial presence test. He also qualifies to use March 14 as a residency starting date, if he chooses. He can disregard up to 10 days of physical presence in the United States because for his first 1 1/2 months in the United States he still had a job and a home in Venezuela and uncertain intentions about staying in the United States. In other words, for that time period Lincoln had a closer connection to a foreign country than to the United States.

First Year Election

Reading Assignment

IRC § 7701(b) (4).

If an alien does not meet either the “green card” test or the substantial presence test for the year of his arrival in the U.S. or for the immediately preceding year, but he meets the substantial presence test for the year immediately following the year of his arrival, he may choose to be treated as a U.S. resident for part of the year of his arrival. To make this choice, he must:

1. be present in the U.S. for at least 31 consecutive days in the year of his arrival; and
2. be present in the U.S. for at least 75% of the number of days beginning with the first day of the 31-consecutive-day period and ending with the last day of the year of arrival. For purposes of this 75% requirement, he may treat up to 5 days of absence from the U.S. as days of presence in the U.S.

In determining whether he qualifies to make this first year election, do not count as days of presence in the U.S. days for which the alien was an exempt individual as discussed earlier.

An alien makes the first year election by submitting an appropriate statement with his tax return (original or extension) for the year of his arrival. A first year election, once made, cannot be revoked without the consent of the Internal Revenue Service.

Read Treas. Reg. § 301.7701(b)-4(c) (3) (v) (C). It specifies what must be contained in the election statement. Filing requirements for an alien making this election are in Treas. Reg. § 301.7701(b)-4(c) (3) (v) (A).

If an alien makes the first year election, his residency starting date for the year of his arrival is the first day of the earliest 31-consecutive-day period of presence that he uses to qualify for the election. He is treated as a U.S. resident for the remainder of the year.

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Example 6

Margaret, a citizen of Australia, came to the U.S. on November 15, 2008. She stayed in the U.S. for the rest of 2008, and she met the substantial presence test for 2009.

Margaret may elect to be treated as a resident for 2008 because she was in the U.S. for 31 consecutive days in 2008, and she was in the U.S. at least 75% of the days from November 15 to December 31, 2008. She must wait until she has met the substantial presence test for 2009 (168 days present in the U.S. in 2009 + 15 days (45 days × 1/3 in 2008) = 183 days) before making her election to be treated as a resident for 2008. She would need to file an extension for the tax year ending 2008.

Residency Ending Date

Reading Assignment

IRC § 7701(b) (2) (B).

In the last year of residency, an alien will not be treated as a U.S. resident after his last day of presence in the United States provided that:

1. for the remainder of the year he has a closer connection to a foreign country; and
2. he is not a U.S. resident at any time during the next calendar year.

For “green card” holders, the last day of residency is the last day of lawful permanent residence.

Example 7

Howard Humboldt had received his green card in 1996. On October 31, 2008, he gave in to his urge to return to his motherland. He went to Immigration and relinquished his green card, never to return to the United States again. He would be considered a resident alien from January 1, 2008 through October 31, 2008. On November 1, 2008, he would assume nonresident alien status.

Interrupted Period of Residence

Reading Assignment

IRC § 7701(b) (10).

If an alien is a U.S. resident during at least 3 consecutive calendar years after 1984, becomes a nonresident, and then again becomes a U.S. resident within 3 calendar years after the end of the initial residency period, he will be subject to U.S. income tax as provided by IRC § 877. This occurs regardless of whether or not the alien has a tax avoidance motive. The alien would not be subject to tax under IRC § 877 if his tax as a nonresident alien under IRC § 871 would be greater.

Effect of Tax Treaties

Reading Assignment

Treas. Regs. 301.7701(b)-7(a) (1).

The rules for determining U.S. residency status do not override tax treaty definitions of residency. For example, if an alien is a U.S. resident under these rules but is a resident of a treaty country (and not a U.S. resident) under an income tax treaty, he may be able to claim the benefits extended to residents of that country. However, the treaty under which he is claiming residence must have a provision for resolution of conflicting claims of residence. This provision may allow an individual considered a resident under IRC § 7701(b) to file as a nonresident.

Reading Assignment

Read Treas. Regs. 301.7701(b)-7(c).

When tax treaty benefits are claimed that override or modify any provision of the Internal Revenue Code, and by claiming these benefits the tax is or might be reduced, a Form 8833 must be attached to the tax return.

Procedural Rules

Procedural rules for IRC § 7701(b) are found in Treas. Reg. § 301.7701(b)-8.

Special Election to be Taxed as Resident Aliens

IRC § 6013(g) allows nonresident aliens married to U.S. citizens or permanent residents to be taxed as residents. In so doing, of course, they must report income from worldwide sources just as their U.S. citizen or U.S. resident spouse must.

Reading Assignment

IRC § 6013(g).

Many aliens make this election in order to file jointly. However, a joint return is only mandatory in the first year of the election. Subsequently, the taxpayer may file jointly or separately, as long as they file as residents until the election is revoked or suspended.

Example 8

Mary, a U.S. citizen for the entire taxable year 2008, is married to Bjorn, a nonresident alien individual. They make the election under IRC § 6013(g) for 2008 by filing a statement of election with a joint return. They must include income from all sources in 2008 and all subsequent years, unless the election is later terminated or suspended. While they must file a joint return for 2008, joint or separate returns may be filed for subsequent years.

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Suspension of the Election

The election is suspended for any tax years during which neither spouse is a U.S. citizen or resident.

Example 9

Carole, a U.S. resident on December 31, 2000, is married to Francois, a nonresident alien. They make the election under IRC § 6013(g) and file joint returns for 2000 and subsequent years. On January 10, 2006, Carole surrenders her green card and becomes a nonresident alien. They may file a joint return or separate returns for 2006. Neither Carole nor Francois is a U.S. resident at any time during 2007; therefore, their election is suspended for 2007. Carole becomes a U.S. resident again on January 5, 2009; their election is no longer in suspense. Income from all sources must be included in their gross income, on joint or separate returns.

Termination of the Election

The election will terminate at the earliest of the following times:

1. Revocation by taxpayers;
2. Death of either taxpayer;
3. Legal separation; or
4. Termination by the Secretary.

Status of Alien Members of the U.S. Armed Forces

Alien members on active duty are treated, for military administrative purposes, as resident aliens and income tax is withheld on the same basis as that of citizens or residents of the U.S. on active duty. At the end of the taxable year, these aliens can be considered nonresidents if they can prove to the IRS that they were, in fact, nonresident aliens during the year.

Enlistees

As a general rule, most alien enlisted personnel in the Armed Forces would qualify as resident aliens for tax purposes. This is nearly always true of the alien who has lived in the U.S. for a number of years before enlistment. In times of peace, the pertinent enlistment requirements of Armed Forces stipulate that no persons may be accepted for enlistment unless they are citizens or have been lawfully admitted to the U.S. for permanent residency under the applicable immigration laws.

On the other hand, aliens who are present in the U.S. merely because of military assignment and who have a genuine residence outside of the U.S. are nonresident aliens.

Citizens of Insular Areas

Individuals who are citizens of Insular Areas (except Guam and Puerto Rico) are technically U.S. citizens under the Organic Acts (laws which made citizens of the Insular Areas also citizens or residents of the U.S.). However, if such persons are not otherwise citizens or residents of the U.S., they are treated as nonresident aliens for tax purposes.

Example 10

Velma was born in the U.S. Virgin Islands of V.I. parents. She has never been in the U.S. and is a U.S. citizen only by virtue of the Organic Act. For U.S. tax purposes, she is a nonresident alien.

Example 11

Assume the same facts as in Example 10, except that Velma decides to come to the U.S. to live permanently. In this case, she would be considered a resident alien for U.S. tax purposes.

Example 12

Melanie was born in American Samoa. Her parents are U.S. citizens born in Georgia. Because Melanie acquired her U.S. citizenship by virtue of her parentage (not the Organic Act), she is considered a U.S. citizen for U.S. tax purposes.

Dual-Status Aliens

Dual-status aliens are both resident and nonresident in the same tax year. Generally, dual-status years for aliens are the year of entry into the U.S. and the year of departure.

Example 13

Horst was born and raised in Germany by German parents. He left Germany in May 30, 2008 and became a permanent immigrant to the U.S. on June 1, 2008. From January through May 2008, he was a nonresident alien because he had not yet acquired his lawful permanent residence status. From June through December 2008, he is considered a resident alien. For the year 2008, Horst has dual-status because he was both a nonresident and a resident alien in the same tax year.

Reading Assignment

IRC § 7701(b) (5) (E) (i).

A Lawful Permanent Resident (LPR) (Green Card Holder) is:

1. An individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and
2. Such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

For tax purposes, resident aliens are treated in the same manner as citizens in almost all circumstances. Nonresident aliens have different rules for taxation but generally they are taxed only on U.S. source income. Dual-status aliens are taxed in a somewhat hybrid fashion (a combination of resident and nonresident features).

This will be discussed in a later chapter.

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Dual-Status Aliens, Continued

IRC § 6013(h) Election

IRC § 6013(h) allows a dual-status taxpayer who is married to a U.S. citizen or permanent resident alien at the end of the year, to elect to be treated as a resident alien for the entire year of entry into the U.S.

Reading Assignment

IRC § 6013(h).

Remember, for U.S. income tax purposes, an alien must be either a resident, nonresident, or dual-status alien.

Summary

1. It is necessary to determine the status of aliens, because the status will determine the rules of taxation.
2. For tax purposes, there are three types of alien status: resident, nonresident and dual-status.
3. Resident aliens must meet one of two tests:
   - The “green card” test
   - The substantial presence test
4. The substantial presence test is based on days of physical presence in the U.S. Certain days do not count toward the substantial presence test for some individuals.
5. Some aliens that meet the “closer connection” exception will be nonresidents even if they otherwise meet the substantial presence test.
6. Dual-status aliens are individuals that are resident aliens for part of the year and nonresident aliens for part of the year.
7. The residency starting date depends on the residency test under which an alien qualifies. In some circumstances, an alien who meets the substantial presence in the year immediately following the year of arrival, but doesn’t qualify as a resident in the year of arrival, can choose to be treated as a resident for part of the year of arrival.
8. Certain nonresident aliens or dual-status aliens can make an election to be treated as resident aliens for the entire tax year.

Instructor Notes

Review the Objective to be sure the students comprehend. These may be on a PowerPoint or flipchart.

Class Exercise

Determine the status of the individuals below as of the end of 2008, without regard to tax treaties. Then determine whether or not they are dual-status for 2008.

1. Yang Sang, an alien from Belgium, is employed by the U.N. and was assigned to work in New York at the U.N. Headquarters and remained there for 5 years. On June 6, 2008, he was transferred to Belgium.

   Answer: Yang Sang is not a dual-status resident – she is a nonresident alien because she is exempt from counting days of presence under IRC §7701(b) (5) (B) (ii) as an employee of an international organization.

2. Stephanni, an alien from Austria, entered the U.S. on an H-1 visa with a musical group in October 2007. The group was engaged for an 8-month concert tour, and returned to New Zealand in May 2008.

   Answer: Stephanni is a nonresident for the entire year. Stephanni was in the U.S. for less than 183 days in the current year, and does not hold green card.

3. Lauren entered the U.S. in June 2008 on a B-2 visa. In September 2008, she obtained a B-1 visa and began working in her profession. She has been renewing her B-1 visa every 90 days while attempting to obtain an immigrant visa.

   The B-2 visa is issued to visitors for pleasure. An alien in B-2 status is not permitted to be paid in any way from a U.S. source. The B-1 visa (visitor for business) is available to scholars planning to pay short visits to one or more campuses. It is not intended for use by a scholar accepting any type of formal academic appointment for a term or longer.

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Answer: Lauren is in violation of her B visas by working. By entering the U.S. in June, she meets the 183-day substantial presence test and is a resident for the entire year.

4. Rick is a citizen of Canada. He lives in Windsor, Canada and has a border-crossing visa, which permits him to work in Detroit, Michigan. He commutes daily across the border.

   Answer: Rick is an individual who regularly commutes from Canada. The days he commutes are not counted as days present in the United States. He is an exempt individual under §§ 7701 (b) (3) (D) (i) and 7701(b) (5).

5. Robert is also a citizen of Canada. He entered the United States in April 2008 to attend the University of Southern California to obtain a teaching degree. He obtained an immigrant visa and intended to remain in the U.S. after graduation.

   Answer: Robert was admitted to the U.S. on an immigrant visa for permanent residence. He has an immigrant visa referred to as a "green card". He was a nonresident until April when he became a lawful permanent resident. He has dual-status.

6. Richard, a citizen of Germany, entered the United States in May 2008 on an H-3 visa as an industrial trainee under a program conducted by a United States corporation that requires living in the U.S. for approximately 4 months.

   Answer: Richard's visa allows him to work up to 4 months in the U.S. He will not meet the substantial presence test. He is a nonresident the entire year.

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7. Change the facts in #6 on the previous page. At the end of the fourth month, Richard was offered a permanent position with the company. He accepted the offer and applied for and obtained an immigrant visa from Immigration authorities.

   Answer: Richard is a nonresident until he obtained an immigrant visa. Then he is a resident.

8. Bill, a subject of the United Kingdom, entered the United States in February 2008 on an immigrant visa and intended to remain 5 years. Due to personal problems, he had to return to the United Kingdom permanently in December of the same year. He did not relinquish his immigrant visa on departure.

   Answer: Bill is a resident until he relinquishes his lawful permanent residence.

9. Clare entered the United States April 2008 on an F-1 visa to study in a 2 year program at a U.S. university. On December 10, 2008, Clare returned to Japan permanently due to personal reasons.

   Answer: Clare, as a student complying with requirements of an F-1 visa, is exempt from counting days for physical presence and is a nonresident.

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Handout 3-A, *Types of Visas and Their Relationship to Alien Status*

For immigration purposes, aliens may be grouped into four categories:

1. Immigrants
2. Non-immigrants
3. Parolees
4. Illegal entrants

Understanding of the type of visa under which an alien entered the U.S. is important in helping to determine status. We will discuss each category separately. We will also discuss residence and non-residence as it applies to each category.

Category 1 – Immigrants

An alien who enters the U.S. on an immigrant visa is admitted for permanent residence. This type of alien is issued an immigrant card, often referred to as a “green card”. There are no restrictions regarding the kind or amount of work which an immigrant may perform in the U.S. Upon the expiration of five years of continuous residence, during which period he is not absent from the U.S. for a continuous period exceeding one year, an immigrant alien is eligible for naturalization. He ceases to be an alien and becomes a citizen when admitted to citizenship by final order of Naturalization Court.

Continued on next page

Category 2 – Non-Immigrants

Non-immigrants are generally nonresident aliens admitted temporarily for specific purposes and periods of time. The visa symbols begin with A and end with L.

- **A Visa**

An alien ambassador, public minister, career diplomatic or consular officer, or other official or employee of a foreign government and his immediate family, and his household and personal servants may enter the U.S. on an A visa. He is admitted on this visa if:

1. He is accredited by a foreign government “recognized de jure by the United States”, and
2. He is accepted by the President or the Secretary of State.

The A-1 visa is called the “diplomatic” visa and is the only visa that extends full diplomatic immunity to the holder. An alien admitted on an A-1 visa is admitted for the duration of the period for which he is recognized by the President or the Secretary of the State as being entitled to that status. Aliens admitted to the U.S. on an A-1, A-2 or A-3 visa are considered nonresident alien individuals for income tax purposes. Exceptions to this rule arise rarely. One exception can arise when a wife becomes estranged or divorced from her husband and remains in this country but not as a part of his immediate family. In such a case, she may lose her status as a nonresident alien despite the fact that she retains her diplomatic visa. In most cases, she would lose her diplomatic visa.

1. **A-1** – The A-1 non-immigrant visa is provided to diplomats representing a foreign government inside the United States. Spouses and dependents are also eligible for the visa. A-1 visa holders generally hold diplomatic status recognized by the U.S. State Department, and are therefore exempt from United States income and other Federal taxes on all compensation received from their foreign government employer under the Vienna Convention on Diplomatic Relations.

Continued on next page

Category 2 – Non-Immigrants (continued)

2. **A-2** – The A-2 non-immigrant visa is provided to officials representing a foreign government inside the United States. Spouses and dependents are also eligible for the visa. A-2 visa holders do not hold diplomatic status recognized by the U.S. State Department; therefore, they receive no exemption from United States income taxes under the Vienna Convention on Diplomatic Relations. However, depending on the particular taxation agreements currently in effect between the United States and the A-2 visa holder's employing country, A-2 visa holders may receive exemption from United States income taxes on compensation received from their foreign government employer under Internal Revenue Code § 893 (if the U.S. State Department has accorded § 893 certification to that country in response to the country's application), an income tax treaty, and/or a consular agreement (which would affect only employees performing consular functions in the United States).

   Note that A-2 visa holders are generally considered nonresident for tax purposes, and therefore must file Form 1040NR rather than Form 1040. As "foreign-government-related individuals", they may not elect to be considered a United States resident under the substantial presence test, since the period of their employment by a foreign government in the United States is considered "exempt" from this test. However, if a nonresident A-2 visa holder is married to a United States resident at the end of the tax year, the couple may elect to file a joint resident (i.e., Form 1040) tax return.

   A-2 visa holders are not authorized to secure employment with entities other than their sponsoring foreign government.

3. **A-3** – The A-3 non-immigrant visa is provided to employees of A-1 and A-2 visa holders. Spouses and dependents are also eligible for the visa. A-3 visa holders do not hold diplomatic status recognized by the U.S. State Department; therefore, they receive no exemption from United States income taxes under the Vienna Convention on Diplomatic Relations.

Continued on next page

Category 2 – Non-Immigrants (continued)

Note that A-3 visa holders are generally considered nonresident for tax purposes, and therefore must file Form 1040NR rather than Form 1040. However, they may elect to be considered as residents for tax purposes if they qualify under either the substantial presence test or "nonresident spouse treated as a resident" test.

A-3 visa holders are not authorized to secure employment with entities other than their sponsoring foreign-government-related employer.

- **B Visa**

The B visa is also referred to as the "visitor's visa". The classification of temporary visitors is subdivided into two visa categories: B-1 (visitors for business) and B-2 (visitors for pleasure). Both categories are admitted for an initial period of 6 months with extensions of temporary stay in increments of not more than 6 months. Immigration law requires that a B visa alien, at the time of entry, have a residence in a foreign country which he has no intention of abandoning. An alien admitted to the U.S. as a temporary visitor cannot work as an employee, for either a domestic or a foreign employer. Usually the B visa alien is present in the U.S. to take a vacation or to undertake some activity with respect to his investment property.

As you can see from the nature of a B visa individual's stay in the U.S., he is usually a nonresident alien. However, the courts have held, in certain rare instances, that individuals admitted to the U.S. on a B visa may be considered resident aliens.

Continued on next page

Category 2 – Non-Immigrants (continued)

- **C Visa**

  The C visa is given to an alien in immediate and continuous transit through the U.S., or an alien who qualifies as a person entitled to pass in transit to and from the United Nations headquarters. In most cases, such an alien must depart from the U.S. within 10 days of his arrival. In no event can the period of stay of an alien in transit exceed 20 days. Aliens admitted to the U.S. under the visa symbols C-2 and C-3 are considered nonresident alien individuals for tax purposes.

- **D Visa**

  Alien crewman serving aboard a vessel or aircraft of foreign registry, including a foreign ship, are given D visas permitting them to land temporarily in the U.S. and depart aboard the vessel or aircraft. The D visa is, in fact, no more than a conditional landing permit. It does not entitle the holder to apply for a permanent resident status, or to remain in the U.S. for a continuous period of longer than 29 days. Alien crewmen admitted to the U.S. on a D visa are nonresident aliens for income tax purposes in the absence of exceptional circumstances.

- **E Visa**

  A "treaty trader" or "treaty investor" is an alien businessman who enters the U.S. on an E visa "under and in pursuance of the provisions of the treaty of commerce and navigation between the United States and the foreign state of which he is a national". These treaties contain so-called "establishment provisions" creating, on a reciprocal basis, the right of citizens of each country to establish and carry on business activities within the other.

Continued on next page

Category 2 – Non-Immigrants (continued)

The spouse and minor children of an alien admitted on an E visa likewise would be admitted on E visas when they accompany him or follow to join him. The immigration status of the spouse and minor children therefore are dependent on the status of the husband. A treaty trader is admitted to the U.S. for an initial period of 1 year with the right of renewal for 1 year at a time.

- **F Visa**

  The F visa is issued only to an alien student who has already been accepted as a matriculated student by an accredited educational institution approved by the Attorney General.

  Before being admitted on an F visa, the student must prove that he has sufficient financial support to enable him to live in the U.S. without accepting employment. For this purpose, on-campus employment pursuant to the terms of a scholarship or fellowship is regarded as part of the academic program of a student taking a full course of study and not as employment. The student must, if required by the admitting INS officer, post a $500 bond guaranteeing his return at the completion of his studies. The initial period of stay of an F visa alien is limited to 1 year subject to yearly renewals as needed to complete a course of study or to obtain a degree. The spouse and minor children of an F visa student may be admitted on visas provided the student can support them.

There are two exceptions to the general rule that an F visa student may not accept or continue employment in the U.S.:

1. He may accept part-time employment because of economic necessity due to unforeseen circumstances arising subsequent to entry; or
2. He may accept or continue employment (other than on-campus employment) in order to obtain practical training in his field of study if he can show that training would not be available to him in the country of his foreign residence.

Continued on next page

Category 2 – Non-Immigrants (continued)

Permission to accept employment is seldom granted and, if granted, for no more than 6 to 12 months at a time.

- **G Visa**

Aliens who are representatives of a foreign government or an international organization covered by the International Organization Immunities Act (for example, the United Nations) and members of their immediate families are admitted to the U.S. on a G visa. A G visa alien is admitted for an initial period of 1 year, subject to renewal without limitation for successive periods of 1 year upon the request of the international organization. As in the case of the A visas and the C visas, individuals admitted to the U.S. on a G visa are considered nonresident aliens for income tax purposes in the absence of exceptional circumstances.

- **H Visa**

An alien coming to the United States to work for a temporary period of time is admitted on an H visa. The Immigration Reform and Control Act of 1986 and the Immigration Act of 1990, as well as other legislation, revised existing classes and created new classes of nonimmigrant admission. Non-immigrant temporary worker classes of admission are as follows:

1. **H-1B** – workers with “specialty occupations” admitted on the basis of professional education, skills, and/or equivalent experience. The H-1B visa program is used by some U.S. employers to employ foreign workers in specialty occupations that require theoretical or technical expertise in a specialized field and a bachelor's degree or its equivalent. Typical H-1B occupations include architects, engineers, computer programmers, accountants, doctors and college professors. The H-1B visa program also includes certain fashion models of distinguished merit and ability and up to 100 persons who will be performing services of an exceptional nature in connection with Department of Defense (DOD) research and development projects or co-production projects.

Continued on next page

Category 2 – Non-Immigrants (continued)

2. **H-1B1** – a national of Chile or Singapore coming to the United States to work temporarily in a specialty occupation. The law defines an H-1B1 specialty occupation as a position that requires theoretical and practical application of a body of specialized knowledge. The beneficiary must have a bachelor's degree or higher (or equivalent) in the specific specialty.
3. **H-1C** – registered nurses to work in areas with a shortage of health professionals under the Nursing Relief for Disadvantaged Areas Act of 1999.
4. **H-2A** – temporary agricultural workers coming to the United States to perform agricultural services or labor of a temporary or seasonal nature when authorized workers are unavailable in the United States.
5. **H-2B** – The H-2B visa category allows U.S. employers in industries with peak load, seasonal or intermittent needs to augment their existing labor force with temporary workers. The H-2B visa category also allows U.S. employers to augment their existing labor force when necessary due to a one-time occurrence which necessitates a temporary increase in workers. Typically, H-2B workers fill labor needs in occupational areas such as construction, health care, landscaping, lumber, manufacturing, food service/ processing, and resort/hospitality services.
6. **H-3** – The H-3 non-immigrant visa category is for aliens who are coming temporarily to the U.S. to receive training (other than graduate medical education or training). The training may be provided by a business entity, academic, or vocational institute. The H-3 non-immigrant visa category also includes aliens who are coming temporarily to the U.S. to participate in a special education training program for children with physical, mental, or emotional disabilities.
7. **H-4** – spouses and children of individuals admitted to the U.S. on an H-1, H-2, or H-3 visa.

Continued on next page

Category 2 – Non-Immigrants (continued)

The period of time for which they are admitted is fixed by the admitting INS officer. An applicant for an H-type visa must be obtained from a U.S. sponsor a “visa petition” to which are attached certifications, affidavits, degrees, diplomas, writings, reviews, and any other evidence attesting to the fact that the applicant is a person of distinguished merit and ability and that the services the applicant is to perform require a person of such merit and ability. Although the period of time for which an H-1 visa holder is admitted into the U.S. is fixed by the admitting INS officer, the residence status of these aliens must be determined under the criteria of Treas. Reg. § 1.7701(b).

An alien may enter the U.S. on an H-2 visa as an unskilled worker, domestic servant, or agricultural or factory laborer, “if unemployed persons capable of performing such service or labor cannot be found in this country”. A petition for an H-2 visa must be filed by the sponsor of the H-2 visa applicant and be supported by a certification from the Secretary of Labor stating that “qualified persons in the United States are not available and that the employment of the beneficiary will not adversely affect the wages and working conditions of workers in the United States similarly employed”. An H-2 visa alien is admitted to this country for an initial period of 1 year, subject to renewal for successive 1-year periods up to 3 years of unbroken stay in the U.S. Since there are no rulings specifically applicable to H-2 visa holders, the resident status of these aliens must be determined under the criteria of Treas. Reg. § §1.7701(b). An alien business or industrial trainee can enter the U.S. on H-3 visa. In order to enter on an H-3 visa, an alien must qualify as an alien “who is coming temporarily to the United States as an industrial trainee”. While the period of stay of an H-3 trainee is limited to a definite period by Immigration and Nationality Act, the regulations under the Act do not prescribe a time limitation applicable to all H-3 trainees. The period of stay is fixed by the admitting INS officer on a case-by-case basis. Normally these individuals are admitted for less than 1 year and are nonresident aliens.

Continued on next page

Category 2 – Non-Immigrants (continued)

- **I Visa**

  Alien representatives of the foreign press, radio, film or other foreign information media enter the U.S. on an I visa. An alien with an I visa is admitted into the U.S. for an initial period of 1 year, subject to renewal for successive 1-year periods. The spouse and minor children of an I visa alien must enter the U.S. on a B visa as temporary visitors. The INS regulations impose a condition on the I visa which is unique to this category: The admission of an alien of the class defined in § 101(a) (15) (I) of the Immigration and Nationality Act of 1952 is an agreement by the alien not to change the information media or his employer until he obtains permission to do so from the District of the Immigration and Naturalization Service.

- **J Visa**

  An alien professor or teacher enters the U.S. on a nonimmigrant J visa. In order to enter on a J visa, he must qualify as a teacher or professor who is coming temporarily to the United States as a participant in a program designated by the Secretary of State, for the purpose of teaching, instructing, or lecturing”. These individuals are commonly referred to as “exchange visitors”. An alien professor or teacher temporarily present in the U.S. on a J visa is admitted for an initial period of 2 years. There are no rulings specifically applicable to J visa professors and teachers. J visa students are affected by the same rules that apply to F visa students.

Continued on next page

Category 2 – Non-Immigrants (continued)

- **K Visa**

  An alien who enters the U.S. solely to conclude a valid marriage with a U.S. citizen or resident (green card holder) within 90 days after entry enters the U.S. on a K visa. Minor children of the alien also enter on a K visa. The entering alien acquires the domicile of his spouse. If the alien lives with his spouse in the U.S. or otherwise declares his intention to reside permanently in the U.S., he is a resident alien from the date of initial entry. If the alien does not reside in the U.S. or otherwise declares his intention not to reside permanently in the U.S., he is a nonresident alien.

- **L Visa**

  The L visa alien is commonly known as an “intra-company transferee”. If an alien has been employed abroad in a capacity that is managerial, executive, or involves specialized knowledge, and he is transferred by his foreign employer to a U.S. branch or subsidiary to work in the same capacity in this country, he and his spouse and minor children accompanying or following to join him may enter on a J visa.

Continued on next page

Category 2 – Non-Immigrants (continued)

Class	Description		PRA*
M-1 visa	Nonacademic student*	legal alien not allowed to work	N
M-2	Spouse or child of M-1 alien	legal alien not allowed to work	N
NATO-1 NATO-2 NATO-3 NATO-4 NATO-5 NATO-6	NATO officer, representative/personnel Spouse/child of principal NATO 1, NATO-2, NATO-3, NATO-4, NATO-5, NATO-6 alien	legal alien allowed to work legal alien allowed to work legal alien not allowed to work legal alien not allowed to work legal alien not allowed to work	N N N N N
NATO-7	attendant/servant/personal employee of principal NATO-1, 2, 3, 4, 5, 6 alien Spouse/child of NATO=7	 legal alien not allowed to work	N N
N-8	Parent of an alien granted permanent residence	legal alien not allowed to work	N
N-9	Child of an alien granted permanent residence	legal alien not allowed to work	N
O-1	Alien with extraordinary ability in science, arts, education, business, or athletics	legal alien allowed to work	N
O-2	Alien accompanying O-2	legal alien allowed to work	N
O-3	Spouse/child of O-1 or 2	legal alien not allowed to work	N
P-1	Internationally recognized athlete or entertainer in an internationally recognized group	legal alien allowed to work	N
P-2	Artist or entertainer in an exchange program	legal alien allowed to work	N
P-3	Artist or entertainer in a culturally unique program	legal alien allowed to work	N
P-4	Spouse/child of P-1, P-2 or P-3 alien	legal alien not allowed to work	N
* PRA indicates a Permanent Resident Alien			
(Table continued on following page)			

Continued on next page

Category 2 – Non-Immigrants (continued)

Class	Description		PRA*
Q-1	International Cultural exchange visitor	legal alien allowed to work	N
Q-2	Irish Peace Process Cultural and Training Program	legal alien allowed to work	N
Q-3	Spouse/child of Q-3	legal alien not allowed to work	N
R-1	Religious worker with nonprofit religious organization	legal alien allowed to work	N
R-2	Spouse/child of R-2	legal alien not allowed to work	N
S-5	Alien supplying information relating to a criminal organization or enterprise	legal alien not allowed to work	N
S-6	Alien supplying information relating to counterterrorism	legal alien not allowed to work	N
S-7	Spouse/child of S-5 or S-6	legal alien not allowed to work	N
TC	Professional business person from Canada (Free Trade Agreement)	legal alien allowed to work	N
TD	Spouse/child of TN	legal alien allowed to work	N
TN	Professional business person from Canada or Mexico (North American Free Trade Agreement)	legal alien allowed to work	N
Asylee	Alien granted asylum under Section 208 of the INA	legal alien not allowed to work	N
CFA/FSM	Alien is a citizen of Micronesia	legal alien allowed to work	Y
CFA/MIS	Alien is a citizen of Republic of Marshall Islands	legal alien allowed to work	Y
CFA/PAL	Alien is a citizen of the Republic of Palau	legal alien allowed to work	Y
Cuban/ Haitian entrant	Alien entered as a refugee/ conditional before 4-1-1980	legal alien allowed to work	N
* PRA indicates a Permanent Resident Alien			
Parolee	Alien paroled into the U.S. temporarily	legal alien not allowed to work	N
Refugee	Alien admitted pursuant to Section 207 of the INA	legal alien allowed to work	Y
TPS	Alien granted temporary protected status	legal alien allowed to work	N

Continued on next page

Category 3 – Parolees	The third category consists of aliens who are not legally admitted into the U.S. but who are paroled into the U. S. at the discretion of the Government. These aliens are referred to as "parolees". Most of the aliens who are paroled into the U. S. rather than admitted under one of the sections of the Immigration and Nationality Act are refugees.
Category 4 – Illegal Entrants	A substantial number of individuals are present in the U.S. in violation of the immigration laws. When such individuals are apprehended, they are subject to deportation. The departing alien tax procedure, which involves an administrative determination as to residency status, is part of the deportation process. All illegal entrants are wanted by the Immigration and Naturalization Service.

Form 8833, *Treaty-Based Return Position Disclosure Under § 6114 or 7701(b)*

Form **8833** (Rev. August 2006)
Department of the Treasury
Internal Revenue Service

Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)

▶ **Attach to your tax return.**

OMB No. 1545-1354

Attach a separate Form 8833 for each treaty-based return position taken. Failure to disclose a treaty-based return position may result in a penalty of $1,000 ($10,000 in the case of a C corporation) (see section 6712).

Name

U.S. taxpayer identifying number

Address in country of residence

Address in the United States

Check one or both of the following boxes as applicable:

- The taxpayer is disclosing a treaty-based return position as required by section 6114 . . . . ▶ ☐
- The taxpayer is a dual-resident taxpayer and is disclosing a treaty-based return position as required by Regulations section 301.7701(b)-7 . . . . ▶ ☐

Check this box if the taxpayer is a U.S. citizen or resident or is incorporated in the United States . . . . ▶ ☐

1 Enter the specific treaty position relied on:

a Treaty country

b Article(s)

2 List the Internal Revenue Code provision(s) overruled or modified by the treaty-based return position

3 Name, identifying number (if available to the taxpayer), and address in the United States of the payor of the income (if fixed or determinable annual or periodical). See instructions.

4 List the provision(s) of the limitation on benefits article (if any) in the treaty that the taxpayer relies on to prevent application of that article ▶

5 Explain the treaty-based return position taken. Include a brief summary of the facts on which it is based. Also, list the nature and amount (or a reasonable estimate) of gross receipts, each separate gross payment, each separate gross income item, or other item (as applicable) for which the treaty benefit is claimed

For Paperwork Reduction Act Notice, see page 3. Cat. No. 14895L Form **8833** (Rev. 8-2006)

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Form 8840, *Closer Connection Exception Statement for Aliens*

Form **8840**

Department of the Treasury
Internal Revenue Service

Closer Connection Exception Statement for Aliens

▶ Attach to Form 1040NR or Form 1040NR-EZ.

For the year January 1—December 31, 2008, or other tax year beginning , 2008, and ending , 20 .

OMB No. 1545-0074

2008

Attachment Sequence No. **101**

Your first name and initial	Last name	Your U.S. taxpayer identification number, if any

Fill in your addresses only if you are filing this form by itself and not with your U.S. tax return	Address in country of residence	Address in the United States

Part I General Information

1 Type of U.S. visa (for example, F, J, M, etc.) and date you entered the United States ▶

2 Of what country or countries were you a citizen during the tax year?

3 What country or countries issued you a passport?

4 Enter your passport number(s) ▶

5 Enter the number of days you were present in the United States during:
2008 ______ 2007 ______ 2006 ______ .

6 During 2008, did you apply for, or take other affirmative steps to apply for, lawful permanent resident status in the United States or have an application pending to change your status to that of a lawful permanent resident of the United States (see instructions)? . . . . ☐ Yes ☐ No

Part II Closer Connection to One Foreign Country

7 Where was your tax home during 2008?

8 Enter the name of the foreign country to which you had a closer connection than to the United States during 2008 ▶

Next, complete Part IV on the back.

Part III Closer Connection to Two Foreign Countries

9 Where was your tax home on January 1, 2008?

10 After changing your tax home from its location on January 1, 2008, where was your tax home for the remainder of 2008?

11 Did you have a closer connection to each foreign country listed on lines 9 and 10 than to the United States for the period during which you maintained a tax home in that foreign country? . . . . . . ☐ Yes ☐ No
If "No," attach an explanation.

12 Were you subject to tax as a resident under the internal laws of **(a)** either of the countries listed on lines 9 and 10 during all of 2008 or **(b)** both of the countries listed on lines 9 and 10 for the period during which you maintained a tax home in each country? . . . . ☐ Yes ☐ No

13 Have you filed or will you file tax returns for 2008 in the countries listed on lines 9 and 10? . . . ☐ Yes ☐ No
If "Yes" to either line 12 or line 13, attach verification.
If "No" to either line 12 or line 13, please explain ▶

Next, complete Part IV on the back.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 15829P Form **8840** (2008)

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Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*

Form **8843**

Department of the Treasury
Internal Revenue Service

Statement for Exempt Individuals and Individuals With a Medical Condition

For use by alien individuals only.

For the year January 1—December 31, 2008, or other tax year beginning , 2008, and ending , 20 .

OMB No. 1545-0074

2008

Attachment Sequence No. 102

Your first name and initial	Last name	Your U.S. taxpayer identification number, if any

Fill in your addresses only if you are filing this form by itself and not with your tax return	Address in country of residence	Address in the United States

Part I General Information

1a Type of U.S. visa (for example, F, J, M, Q, etc.) and date you entered the United States ►

b Current nonimmigrant status and date of change (see instructions) ►

2 Of what country were you a citizen during the tax year?

3a What country issued you a passport?

b Enter your passport number ►

4a Enter the actual number of days you were present in the United States during:

2008 ________ 2007 ________ 2006 ________

b Enter the number of days in 2008 you claim you can exclude for purposes of the substantial presence test ►

Part II Teachers and Trainees

5 Enter the name, address, and telephone number of the academic institution you attended during 2008 ►

6 Enter the name, address, and telephone number of the director of the academic or other specialized program you participated in during 2008 ►

7 Enter the type of U.S. visa (J or Q) you held during: ► 2002 ________ 2003 ________ 2004 ________ 2005 ________ 2006 ________ 2007 ________ . If the type of visa you held during any of these years changed, attach a statement showing the new visa type and the date it was acquired.

8 Were you present in the United States as a teacher, trainee, or student for any part of 2 of the 6 prior calendar years (2002 through 2007)? . . . . ☐ **Yes** ☐ **No**

If you checked the "Yes" box on line 8, you cannot exclude days of presence as a teacher or trainee unless you meet the *Exception* explained on page 3.

Part III Students

9 Enter the name, address, and telephone number of the academic institution you attended during 2008 ►

10 Enter the name, address, and telephone number of the director of the academic or other specialized program you participated in during 2008 ►

11 Enter the type of U.S. visa (F, J, M, or Q) you held during: ► 2002 ________ 2003 ________ 2004 ________ 2005 ________ 2006 ________ 2007 ________ . If the type of visa you held during any of these years changed, attach a statement showing the new visa type and the date it was acquired.

12 Were you present in the United States as a teacher, trainee, or student for any part of more than 5 calendar years? . . . . ☐ **Yes** ☐ **No**

If you checked the "Yes" box on line 12, you must provide sufficient facts on an attached statement to establish that you do not intend to reside permanently in the United States.

13 During 2008, did you apply for, or take other affirmative steps to apply for, lawful permanent resident status in the United States or have an application pending to change your status to that of a lawful permanent resident of the United States? . . . . ☐ **Yes** ☐ **No**

14 If you checked the "Yes" box on line 13, explain ►

For Paperwork Reduction Act Notice, see page 4. Cat. No. 17227H Form **8843** (2008)

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Glossary

- **Passport:** Any travel document issued by a competent authority showing the bearer's origin, identity, and nationality (if any), which is valid for admission of the bearer into a foreign country.
- **Real property income choice:** A nonresident alien who owns or has an interest in U.S. real property (not effectively connected) that is held for the production of income may choose to treat all income derived from that property as effectively connected.
- **Sailing permit:** see “Certificate of Compliance”.
- **Tax clearance:** see “Certificate of Compliance”.
- **Termination assessment:** A tax assessment made when the district director determines that an alien's departure jeopardizes the collection of income tax for the current or preceding taxable year. In such an assessment, the taxable period of the alien is terminated and he or she is required to file returns and pay the tax liability.

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International Technical Training

Chapter 3

Taxation of Nonresident Aliens

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 2 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • Pencils/Pens • Highlighters
Participant References	• Publication 515 and 519 • Complete copy of Form 1040NR • CCH Disk
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides • Flipcharts and markers
Training Aids	• Form 1040NR • Tax Court Case*, Abeid vs. Commissioner*, 2004 TNT 126-4

Overview

Introduction

The first step in taxation of aliens is to determine their status. Once the nonresident alien status is determined, the next step is to analyze the income that will be taxed by the U.S. Generally, the nonresident alien is taxed only on U.S. source income – either at graduated rates or at a flat percentage.

Certain tax treaty provisions may also affect the taxation of an alien.

Furthermore, the nonresident spouse of a U.S. citizen or resident alien may elect to be taxed as a resident under IRC § 6013(g).

The nonresident alien is required to report his income on Form 1040NR.

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and PowerPoint slides.

Objectives

At the end of this lesson, the student will be able to:

- Determine whether a nonresident alien's income is effectively or not effectively connected with the conduct of a trade or business in the U.S.
- Correctly compute tax for a nonresident alien.

Continued on next page

Overview, Continued

Contents

This lesson covers the following topics:

Definitions

- ☑ **<u>Effectively connected income</u>**: income, other than certain investment income, earned from sources within the United States while engaged in a U.S. trade or business.
- ☑ **<u>Not effectively connected income</u>**: income that does not meet the criteria to be effectively connected.

Effectively and Not Effectively Connected Income

Reading Assignment

Read IRC §§ 864(c) (1), 871(a) (1), 871(b), 864(c) (6), and 864(c) (7).

One of the most important concepts involved in taxation of nonresident aliens is whether their income **is** or **is not** effectively connected with the conduct of a U.S. trade or business during the taxable year.

In general, the U.S. taxes nonresident aliens only on their U.S. source income. Therefore, you must determine the total U.S. source income before proceeding in the computation of tax.

The U.S. has two methods of taxing the U.S. source income of nonresident aliens. The income is taxed either: 1) on gross income at a flat rate of 30% or lower tax treaty rate; or 2) on net income using graduated tax rates schedules.

Effectively connected income is taxed on net at the graduated rates. Not effectively connected income is taxed on gross at the flat rate. The flat rate is 30%, but some tax treaties provide for a lower rate on specified income items.

Income from a trade or business in the U.S. is effectively connected income. Activities that constitute being engaged in a U.S. trade or business include:

1. performing personal services in the U.S. for wages, salaries, fees, tips, bonuses, honoraria, commissions, etc. This includes income received in the year the services are performed as well as income for services received in a later year;
2. owning and operating a business in the U.S. which involves the sale of services, products, or merchandise in the ordinary course of business. If the business ceases to exist, income or gain from the sale of any property connected with the business is considered effectively connected for a period of 10 years from the date of cessation;
3. being a member of a partnership that is engaged in a business in the U.S. (It is not necessary that the alien actually be present in the U.S.);

Continued on next page

4. being the beneficiary of an estate or trust that is engaged in U.S. business; and
5. trading in securities. (Aliens are not engaged in a trade or business in the United States if they are trading in stocks, securities, and commodities through a U.S. resident broker or other agent **unless** they have a U.S. office or other fixed place of business at any time during the tax year through which, or by direction of which, they carry out their transactions. If the transactions are for their personal account, the transactions are generally **not** "effectively connected").

If you are engaged in a trade or business in the U.S., you will have income (gain or loss) that is "effectively connected." This income, along with other income from U.S. sources, other than investment income, is generally treated as effectively connected income. It is also possible that some income from foreign sources may be effectively connected with a trade or business in the U.S. When making a determination whether income is or is not effectively connected, all factors concerning the receipt of the income must be taken into consideration. For additional information regarding factors to consider when determining whether income is effectively connected read Treas. Reg. §§ 1.864-2(c) (1) and 1.864-2(c) (2) (i).

Reading Assignment

Read Treas. Reg. §§ 1.864-2(c) (1) and 1.864-2(c) (2) (i).

Example 1

Edward is a nonresident alien who worked in the U.S. for 6 months as an employee of a U.S. company. His income from that job was effectively connected. Edward received dividends of $800 from a different U.S. corporation while he was in the U.S. The fact that he was engaged in a trade or business in the U.S. by virtue of his employment does not make his dividend income effectively connected since it was unrelated to his income as an employee.

Continued on next page

Effectively and Not Effectively Connected Income, Continued

Reading Assignment

Read Treas. Reg. §§ 1.864-2(c) (1) and 1.864-2(c) (2) (i).

Example 2

Roderick is an alien engaged in a manufacturing business. His business has branches abroad and in the U.S. He maintains a factory at one of his U.S. branches. Roderick hires a brokerage house in the U.S. to manage securities, which are purchased with funds from general surplus reserves. The brokerage house is instructed to deposit all income and gains from these securities in Roderick's U.S. bank account. The funds invested in the securities are not necessary to provide for the present needs of the U.S. branch. Accordingly, the securities are not held in direct relationship to the business conducted in the U.S. by Roderick, and the income and gains are not effectively connected income.

Example 3

"Viola" is a French corporation that manufactures designer scarves. The corporation maintains a branch in New York City that acts as the importer and distributor of the scarves manufactured in France. By reason of these branch activities, "Viola" is engaged in business in the United States. The branch in the United States is required to hold a large current cash balance for business purposes, which varies from time to time because of seasonal demands. When large cash balances are not required, the branch invests in U.S. Treasury bills. Since the Treasury bills are held to meet the present needs of the business conducted in the United States, they are held in direct relationship to that business. Therefore, the interest on these bills is effectively connected with the conduct of the business in the United States.

Special Rules for Nonresident Aliens

Reading Assignment

Read IRC § 864(b) (1).

Personal Services

A nonresident alien's U.S. personal service income may be considered foreign source (and, therefore, not effectively connected) if the individual:

1. is in the United States for a period of time not exceeding a total of **90** days during the tax year; **and**
2. the personal service income is not in excess of $3,000 compensation for personal services; **and**
3. the individual is employed by a nonresident firm, individual, corporation or partnership not engaged in a trade or business within the United States, or is employed by a foreign office of a U.S. citizen or resident individual, corporation, or partnership.

The taxpayer must satisfy all three conditions in order for the income to be considered foreign source. The one condition that most aliens might not meet is the requirement that they be employed by a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business in the U.S. See IRC § 861(a) (3).

Instructor Notes

Instructor may ask students to read the IRC cites or may paraphrase.

Reading Assignment

Read IRC § 871(i).

Continued on next page

Special Rules for Nonresident Aliens, Continued

Interest

Key Point:

- The interest earned on certain deposits, which is NOT effectively connected with a trade or business, is not taxable.

Pensions

If a nonresident alien receives pension income from the United States, the source of the original income must be determined to see how the pension will be treated. For example, Pierre worked at the U.S. Embassy in Paris as a foreign service national for 30 years and retired. He receives a pension from the Department of State. Is this pension from the United States going to be taxed in the United States? The answer is no, as Pierre rendered no services in the United States. If he had, an allocation would have to be made.
Refer to Handout 4-A – Revenue Ruling 79-388.

If an NRA is engaged in a U.S. trade or business during the tax year because the NRA is performing personal services in the United States, pension income attributable to that service is effectively connected.

Continued on next page

Special Rules for Nonresident Aliens, Continued

Reading Assignment

Read IRC § 871(d).

Real Income Property Election

A taxpayer who owns property in the U.S. can elect to have that income treated as effectively connected and be taxed on net income at graduated rates even if the taxpayer has not otherwise engaged in a U.S. trade or business. The nonresident alien need not live in the U.S. to make this election.

Normally income from rental property in the U.S. owned by a nonresident alien is considered not effectively connected with a U.S. trade or business. By making this election, the nonresident alien can claim expenses of the rental property on Schedule E. Furthermore, a rental loss created by this election can be used to claim a net operating loss.

Refer to Treas. Reg. § 1.871-10(c) (2). A nonresident alien taxed at the flat rate, 30%, is not allowed to deduct rental expenses.

Instructor Notes

Ask students: How can a nonresident alien claim expenses on a rental property?

Answer: By electing to have that income treated as effectively connected to a U.S. trade or business and be taxed at graduated rates.

Reading Assignment

Read IRC § 871(a) (2) and Treas. Reg. §§ 1.871-7 (d) (1) and 1.871-7(d) (2).

Continued on next page

Special Rules for Nonresident Aliens, Continued

Capital Gains

U.S. real property capital gains are taxed as effectively connected with a U.S. trade or business regardless of whether the individual has revoked the Real Property Income Election or was never in the U.S. A special tax computation must be made which will be discussed in a later lesson.

U.S. personal property capital gains that are effectively connected with a U.S. trade or business are taxed at the graduated rates.

U.S. personal property capital gains that are **not** effectively connected with a U.S. trade or business are taxed at the flat 30% or lower tax treaty rate if the nonresident alien was in the U.S. 183 days or more. If the nonresident alien was in the U.S. for less than 183 days, the gain is exempt from U.S. taxation. See IRC § 865.

Reading Assignment

Read Treas. Reg. § 1.871-8(b) (2) (ii) and 1.871-7(d) (4).

Capital Losses

- **Effectively Connected to a U.S. Trade or Business**

If the nonresident alien is engaged in a U.S. trade or business during the taxable year and has capital losses directly related to that trade or business, the losses are allowable. They are reported on Schedule D and carried to page 1 of the Form 1040NR (to be discussed later in detail). The losses are included in the graduated rate computation (to be discussed later).

- **Not Effectively Connected to a U.S. Trade or Business**

If the nonresident alien is not engaged in a U.S. trade or business, his U.S. capital losses may be used to offset capital gains. However, losses in excess of gains may not be used. These gains and losses are reported on the Form 1040NR, page 4.

Foreign Source Income

Reading Assignment

Read IRC § 864(c) (4).

Certain foreign source income of a nonresident alien can be considered effectively connected and therefore is taxed at the graduated rates. The foreign source income involved is limited to three specific types:

1. Rents, royalties, gains or losses from **intangible** property located outside the United States (i.e., patents, copyrights, goodwill).
2. Dividends, interest, and gain or loss from the sale of stocks, notes, or bonds derived in the conduct of banking or financing business in the United States.
3. Income, gain or loss from selling outside the United States, but through a U.S. office, business inventory or stock in trade.

To be covered by these situations, the nonresident alien must have an office or fixed place of business in the United States, and the income specified must be attributable to the usual (as distinct from casual) activities of that place of business. Because nonresident aliens are not usually taxed on foreign source income, the exceptions should be kept in mind.

Foreign tax credit usually applies only to U.S. citizens and residents because the computation of the credit is based on the premise that the taxpayer is being taxed by the United States on income from foreign sources that has been taxed by a foreign country. The exceptions given above probably constitute the only circumstances allowing a nonresident alien to claim the foreign tax credit.

Instructor Notes

Ask students: Can a nonresident alien claim a foreign tax credit?

Continued on next page

Exercise 1

Indicate whether the income of each of the NRAs in the following situations is effectively connected or not effectively connected income:

Effectively Connected? (Yes or No)

a. Trixie Passerby is employed in the United States earning $10,462 wages in 2008.

_____X____Yes ___________No

b. Tabitha Persian was a resident alien of the U.S. for 20 years, employed by a U.S. firm. In 2008, Tabitha retired to Italy on an annual pension of $4,000 paid by her former employer. She had no other U.S. income in 2008, and has no intention of ever moving back to the United States.

_____X____Yes ___________No

c. Thomas Purring, citizen of Belgium, has never resided in the United States, but as a crewmember on a merchant vessel, often stops in New York. He maintains a savings account at the N.Y. Bowery Bank and received $1,500 in interest from the account in 2008.

___________Yes _____X____No

d. Susan Snead, a citizen of Brazil, resided in the U.S. for 4 years. She quit working on November 30, 2008 and returned to Brazil with no intentions of returning to the U.S. Susan received her final paycheck on January 7, 2009.

_____X____Yes ___________No

Form 1040NR

Reading Assignment

Read Treas. Reg. §§ 1.6012-1(b) (1), (b) (2), and (b) (3).

Instructor Notes

Instructor may have students read the IRC cites or may paraphrase. Instructor may use PowerPoint and display a Form 1040NR for the class in addition to handing out copies to the students for the exercises.

Ask students: Who can file a F1040NR? What are the criteria for filing a Form 1040NR?

Who Must File Form 1040NR

Form 1040NR must be filed by the following:

1. Nonresident aliens engaged in a trade or business in the U.S. with U.S. income, even though their gross income may be less than the personal exemption.
2. Nonresident aliens not engaged in a trade or business in the U.S. with income, the tax on which was not satisfied by withholding at source.
3. A representative or agent responsible for filing the return of an individual described in (1) and (2) above.
4. A fiduciary for a nonresident alien estate or trust.
5. Nonresident aliens who wish to claim the benefit of any deductions or exemptions.
6. Nonresident aliens making a claim for refund.

Form 1042-S is one of the forms received by nonresident aliens indicating income tax withheld.

Due Date of Form 1040NR

Form 1040 NR has a filing date of 4/15/xx if there is compensation subject to withholding on the return. Otherwise, the due date is 6/15/xx.

Continued on next page

Form 1040NR, Continued

Reading Assignment

Read IRC §§ 6013(a) (1) and 2(b) (3).

Filing Status

There are limitations on the filing statuses that nonresidents may use. For this reason, only allowable statuses appear on Form 1040NR. A nonresident alien can elect under IRC § 6013(g) to be treated as a resident alien and therefore be eligible to file a joint return. Individuals making that election would not use Form 1040NR.

Instructor Notes

Read IRC § 7703.

Instructor may have students read the IRC cites or may paraphrase.

At this point, instructor needs to obtain copies of Form 1040NR and distribute to class.

Ask the students: Name the countries where U.S. Nationals living apart from their spouses can file single.

Answer: Canada, Mexico, Republic of South Korea, and U.S. Nationals. Also, students and business apprentices who are residents of India.

Ask the students: What are the requirements?

Answer:

Ask the students: What is this provision sometimes called? Why?

Answer: Abandoned spouse.

Continued on next page

Married Filing as Single

Married residents of Canada, Mexico, and U.S. Nationals who are living apart from their spouses may file as single, if they meet the following requirements:

1. They pay more than half of the cost of maintaining a home in the U.S.; and
2. Their spouse did not live in the home during the last 6 months of the year; **and**
3. For over 6 months of the year, their home was the principal residence of their children or stepchildren, who can be claimed as dependents.

This provision, sometimes referred to as the "abandoned spouse" provision, also applies to U.S. citizens. Aliens who can qualify for this provision must be from one of the above mentioned countries because these are the only aliens who may claim exemptions for their children. All other married nonresident aliens must file as married and be taxed under the "married filing separate" rates.

Qualifying Widow(er)

An alien can claim this filing status only if all of the following conditions are met:

1. The nonresident alien was a citizen of Mexico, Canada, South Korea, or is a U.S. National. If from South Korea, the taxpayer and his child must have lived in the U.S.
2. The nonresident's spouse died during either of 2 prior taxable years, and the taxpayer has not remarried.
3. The nonresident has a child or stepchild whom he/she can claim as a dependent.
4. The alien's home in the U.S. was the primary residence of his dependent child or stepchild for whom an exemption could be claimed.
5. The alien filed, or could have filed, a joint return in the year of the spouse's death.
6. The nonresident paid over half the cost of keeping up the home.

Continued on next page

Instructor Notes

Ask the students: What if the resident met two of the conditions can he still claim this filing status?

Answer:

Reading Assignment

Read IRC § 873(b) (3).

Exemptions

Generally nonresident aliens may only claim an exemption for themselves. However, residents of American Samoa (U.S. Nationals), Canada, Mexico, or South Korea are allowed additional exemptions.

Exception: Residents of India who were students or business apprentices may be able to claim an exemption for their spouse and dependents. (See Publication 519, Article 21(2) of the U.S. – India Income Tax Treaty, and the Form 1040NR instructions).

Under provisions of the U.S. tax treaties with South Korea, exemptions for the taxpayer's spouse and children are prorated on the basis of the ratio of U.S. source gross income to total gross income for the entire year. The spouse and children must have lived with the taxpayer in the United States.

There is no line on Form 1040NR for a taxpayer to make the computation of the partial exemptions allowable for a South Korean spouse and children. Taxpayers should attach a separate computation sheet explaining the partial exemption and showing the computation. An unexplained partial exemption could otherwise result in a Service Center correction.

This example shows the explanation and computation that should be used by citizens of South Korea. Exemption line, page 2, Form 1040NR, should be asterisked (*) and referred to an attached computation.

Exemptions are prorated under provisions of Article 4 (5) of the U.S.-South Korean Income Tax Treaty.

Continued on next page

Instructor Notes

Show students where the information for the following example would go on a Form 1040NR.

Example

Explanation of exemption line, page 2, Form 1040NR 2008:

Only husband was employed in the United States. Wife and one child accompanied taxpayer to U.S.

$ 6,000 U.S. earned income in 2008 (to 3-31-08)
  25,000 Korean earned income in 2008 (after 3-31-2008)

$31,000 = Total income earned during 2008

$ 6,000 = 19.35% U.S. earned income

2 exemptions (wife and child) × $3,500.00
(2008 exemption amount) = $7,000.00 × 19.35% = $ 1,354.50.

Partial exemption allowed for wife and child; full exemption for taxpayer. Exemptions claimed on Line 37, page 2, Form 1040NR.

$1,354.50 allowed for spouse and child
$3,500.00 allowed for primary taxpayer

$4,854.50 total amount for exemptions. Round up $4,855.

Nonresident aliens from Canada, Mexico, or American Samoa can claim the full exemption for their spouse and children. The shaded areas on the 1040NR indicate the unallowable exemptions.

Note: If Form 1040NR does not provide a space to claim a filing status or an exemption, then that item is not allowable.

Continued on next page

Effectively Connected Income

The first income section of Form 1040NR is effectively connected income. Income that is not effectively connected income is reported on page 4 of Form 1040NR.

Adjustments to Income

Adjustments to income include, among others: IRA deduction, student loan interest deduction, moving expense, self-employed health insurance deduction, and scholarship and fellowship exclusions. Itemized deductions include state and local income taxes, contributions, casualty and theft loss, unreimbursed employee expenses and miscellaneous deductions.

IRA Deduction

A nonresident alien can deduct contributions made to a traditional IRA. For 2008, the smaller of $5,000 or taxable compensation effectively connected to the U.S. trade or business can be deducted. If the nonresident alien was covered by a retirement plan, the IRA deduction may be reduced or eliminated.

Student Loan Interest Deduction

A nonresident alien may deduct interest paid on a student loan. Certain requirements have to be met in order to deduct it.

Moving Expenses

A nonresident alien temporarily in the United States earning taxable income performing personal services can deduct moving expenses. The deduction is generally limited to moves to or within the United States or its possessions. In order to take the deduction, provisions of IRC § 217 would apply.

Important Point

Key Point:

- An important point to remember is that once the alien leaves the U.S., his income will no longer be subject to U.S. tax; therefore, the moving expense back to the foreign country is not allowable.

Continued on next page

Itemized Deductions

Itemized deductions apply only to nonresidents who report effectively connected income. No deductions are allowed against not effectively connected income.

State and Local Income Taxes

Usually this will be the amount withheld as shown on the taxpayer's W-2 form.

Contributions

Only those contributions made to qualified U.S. charities may be deducted.

Casualty and Theft Loss

Although the taxpayer must be earning effectively connected income, the property involved in the casualty does not need to be related to the income in order to qualify.

For instance, a taxpayer temporarily employed in the U.S. can deduct a casualty loss on a car used in the U.S., even though the car was not used in an effectively connected trade or business.

Only property located in the U.S. at the time of the casualty qualifies for the loss deduction.

Job Expenses and Most Other Miscellaneous Deductions

This section is provided for business deductions related to the taxpayer's effectively connected income such as unreimbursed travel expenses (discussed next). Other examples are: union dues, safety equipment and small tools needed for your work, dues to professional organizations, subscriptions to professional journals, and tax return preparation fees.

Continued on next page

Travel Expenses

A nonresident alien may deduct ordinary and necessary travel expenses while temporary performing personal services in the U.S. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for 1 year or less.

Deductible travel expenses are:

1. Transportation — airfare, local transportation including train, bus, etc.
2. Lodging — rent paid, utilities (do not include telephone), hotel or motel room expenses, and
3. Meal expenses — actual expenses allowed if records were kept, or a standard meal allowance amount depending on the date and area of the travel.

An expense, or part of an expense, that is allocable to U.S. tax-exempt income, including income exempt by a tax treaty, cannot be deducted.

Travel expenses for other members of the family cannot be deducted.

Other Information Section

This section should not be overlooked during the examination. Pay particular attention to Item M, where the taxpayer provided information on any treaty exclusion claimed. The excluded income would not have been reported in the Income section.

The information furnished by taxpayers in this Other Information section is very helpful to classification personnel in choosing returns for audit.

Tax Computation on Effectively Connected Income

See Form 1040NR, page 2, lines 35-41.

Adjusted gross income is reduced by any itemized deductions to arrive at taxable income before exemptions. No standard deduction is allowed (except for students and business apprentices from India as specified on Publication 519). A nonresident alien with income effectively connected with a U.S. trade or business must itemize deductions.

Reading Assignment

Refer to IRC § 63(c) (6).

Alternative Minimum Tax

Aliens may be subject to alternative minimum tax on gain from the sale of U.S. real property. A special computation must be done. This is covered in a later chapter.

Credits

Nonresident aliens that received effectively connected income may claim some of the following credits.

Foreign Tax Credit

If an alien receives income from sources outside the U.S. that is effectively connected with a trade or business in the U.S., a credit may be claimed for any income taxes paid or accrued to any foreign country or U.S. possession on that income.

Child and Dependent Care Credit

In order to qualify for the credit, the alien must have paid someone to care for a dependent under age 13, or a disabled dependent, or a disabled spouse, so the alien can work or look for work. The amount of the child and dependent care expense that qualifies for the credit in any tax year cannot be more than the alien's earned income from the United States.

Continued on next page

Form 1040NR

Child Tax Credit

Aliens who have qualifying children, i.e., a child, descendant, stepchild, or eligible foster child who is a U.S. citizen and for whom the taxpayer may claim a dependency exemption and who is less than 17 years old as of the close of the tax year, are entitled to the child tax credit.

Payments and Other Credits

The items reported in these sections are much the same as on Form 1040. One important difference is the tax on not effectively connected income. It is, of course, added to the tax on effectively connected income.

Adoption Credit

Taxpayers may claim a nonrefundable credit on Form 8839 of up to $11,650 for qualified adoption expenses for each eligible child in 2008. The credit is phased out ratably for taxpayers with a modified adjusted gross income (AGI) over $174,730 and no credit is allowed to taxpayers with a modified adjusted gross income of $214,730 or more. A 5-year carry-forward is provided for the unused portion of such credit that exceeds the limitation imposed.

Other Credits

An alien may claim any of these other credits:

- Credit for prior year minimum tax – if a mortgage credit certificate was received from a state or local government.
- Mortgage interest credit – if alternative minimum tax was paid in the prior year.
- General business credit – usually applies to individuals who are partners, self employed, or who have rental property.
- Qualified electric vehicle credit – if a new electric vehicle was placed in service during the year.

Other Taxes

Tax on Not Effectively Connected Income

The entire page 4 of Form 1040NR is restricted to various types of not effectively connected income which are received during the year. The income is broken down by the rate of tax applicable to that type of income. Any tax withheld at source on that income is also reported here. The bottom of page 4 provides a schedule for sales and exchanges of property that are from U.S sources and not effectively connected with a U.S. business.

The statutory rate of tax on not effectively connected income is generally 30%. The 5%, 10% and 15% rates commonly apply to various types of income eligible for tax treaty benefits.

Publication 515 contains reference charts showing the treaty rates of tax on various types of U.S. source income received by nonresident aliens. If in doubt, consult the tax treaty.

Social Security Benefits

Social Security benefits are taxable to nonresident aliens. A nonresident alien must include 85% of any U.S. Social Security benefit and equivalent railroad retirement benefits received. The benefits are considered U.S. source income not effectively connected with a U.S. trade or business. It is subject to the flat 30% unless exempt or taxed at a lower tax treaty rate. Tax treaties with the following countries specifically exempt Social Security benefits from U.S. taxation.

Egypt	Romania
Germany	United Kingdom
Italy	Canada
Japan	Ireland

Generally, the payer withholds the tax at the effective or statutory rate. This is paid to the IRS and Form 1042-S is issued to the recipient. As stated earlier in this lesson, if a nonresident has only not effectively connected U.S. income and the tax withheld at source fully covers the liability, no return is required. A return must be filed, however, in order to claim a refund of an overpayment if the withholding agent has already filed and paid the tax to the IRS.

Continued on next page

Social Security Tax and Medicare Tax on Tip Income Not Reported to Employer	Nonresidents, who are subject to Social Security and Medicare tax and receive tips of $20 or more in any month and did not report the full amount to the employer, must pay Social Security and Medicare taxes on the unreported tips.
Transportation Tax	Nonresident aliens are subject to a 4% tax on U.S. source gross transportation income that is not effectively connected with a U.S. trade or business.
Household Employment Tax	Nonresident aliens that have household employees may need to withhold and pay employment taxes (Social Security, Medicare and Federal unemployment taxes).
Self-Employment Tax	Nonresident aliens are not liable to pay self-employment tax.

Summary

1. Nonresident aliens must pay U.S. tax on U.S. source income using Form 1040NR.
2. Effectively connected income is taxed at graduated rates.
3. Not effectively connected income is taxed at a flat percentage rate.
4. Interest, personal service income, and capital gains may be exempt from taxation if certain requirements are met.
5. Nonresident aliens are not entitled to certain tax benefits available to U.S. citizens and resident aliens.

Instructor Notes

Display and state the *Objectives* again. May use flipcharts, transparency, and PowerPoint slides.

Class Exercises

Exercise 1

Determine whether the following income paid in 2008 to a nonresident alien is or is not connected with a trade or business in the United States, and whether it is taxed at graduated rates or the flat 30% (or lower tax treaty rate):

Check the appropriate column.

		Effectively Connected	Not Effectively Connected	Taxed at Graduated Rates	Taxed at Flat 30% or Lower Treaty Rate
a.	NRA worked in the United States during 2008 and earned wages of $17,000. Personal Services.	***Yes, effectively connected.***		X	
b.	NRA received dividend income of $1,500 in 2008 on his U.S. investments. He does not reside in the United States and this is his only connection with the United States.	***Not effectively connected. See p. 4-5 #5.***			X
c.	Taxpayer has been a resident alien who had worked in the United States for a U.S. company for 30 years. In 2007, he retired to his home country, giving up his residency. He received a pension of $12,000 from the U.S. company during 2008.	***Yes, effectively connected. Income received from the performance of personal services in another year is treated as effectively connected in the year received, if it would have been so treated in the year the services were performed.***		X	
d.	NRA who had never been in the United States inherited a piece of undeveloped acreage from an uncle in New Mexico. NRA **sold** the land in 2008 for a $20,000 profit. NRA had never received any income from the property.	***Yes, effectively connected.***		X	

Continued on next page

Exercise 2

Tammy Tanglewood, a citizen of Ireland, is a married nonresident alien who earned $900 per month for the 5 months she worked in the United States for a U.S. company as part of a training program during 2008. Federal income tax of $117 per month was withheld from her salary.

Tammy entered the U.S. on July 1, 2008, on an H-3 visa (trainee) and departed on December 20, 2008.

In addition to her salary, Tammy received the following dividends from the U.S. corporations during 2008. Tax was withheld at source in the amounts shown:

	Dividends	Tax Withheld
G.E. Corporation	$500	$75
Boise-Cascade	300	45
Coca Cola	260	39

According to the tax treaty between the United States and Ireland, the proper tax rate for corporation dividends is 15%.

Tammy's Irish company paid for all of her travel expenses during her stay in the United States and she made a proper accounting to them of her expenses.

Determine the following:

a. Filing status

Answer: Married Filing Separate

b. Number of exemptions

Answer: 1 exemption

Continued on next page

Exercise 2
(continued)

c. Effectively connected income amount

   Answer: $4,500

d. Taxable income

   Answer: $1,100

e. Total tax withheld

   Answer: $744

f. Total non-effectively connected income amount:

   Answer: $1,060

g. Tax on the non-effectively connected income of $1060

   Answer: $159

Instructor Notes

1. Instructor should go over the answers and be sure each student has the correct answer.
2. Read through with the class Handout 4-A – Rev. Rul. 79-388, and Handout 4-B – Taxation of Nonresidents.

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Handout 4-A – *Revenue Ruling 79-388, 1979-2 CB 270*

Section 862 — Income from Sources without the United States

A nonresident alien received pension payments from a domestic employer's qualified noncontributory pension plan for services performed in prior years both within and without the U.S. The portion of each payment that is attributable to earnings of the pension plan and the portion attributable to the employer's contributions with respect to services rendered within the U.S. are income from sources within the U.S. for purposes of §§ 871(a)(1)(A) and 1441(a) of the Code.

Issues

To what extent are the pension payments from a United States trust to a nonresident alien subject to Federal income and withholding taxes, under the facts below?

What is the proper allocation of income between United States and foreign sources of pension payments received by a nonresident alien individual, under the circumstances described below?

Continued on next page

Facts

A, a nonresident alien individual, began employment with a foreign branch of domestic corporation *X* in the foreign country of which *A* was a citizen. Subsequently, *A* was transferred to *X*'s office in the United States and remained in such employment until retirement on December 31, 1978. During *A*'s employment in the United States, *A* remained a citizen of the foreign country and *A*'s status in the United States during such period was that of a resident alien individual. Immediately upon retirement, *A* returned to the foreign country and *A*'s status changed to that of a nonresident alien individual. Pension payments from *X*'s retirement plan, which included credit for services performed by *A* for *X*'s foreign branch, commenced in January 1979.

While employed in *X*'s branch in the foreign country, A was a participant in the United States retirement plan that *X* established and contributed to for all employees of *X*. The retirement plan invested the contributions and received income from such investments.

X's retirement plan is a noncontributory arrangement with respect to employees that qualify, under section 401(a) of the Internal Revenue Code, as a self-administered trusted plan, and is exempt from taxation under section 501(a). Section 871(f), relating to an exclusion from gross income for amounts received from certain qualified pension plans, does not apply to any amounts received by *A* from *X*'s retirement plan.

Continued on next page

Law and Analysis

Section 871(a) (1) (A) of the Code imposes a tax of 30% of the amount received by a nonresident alien individual as, among other items, interest, dividends, salaries, wages, annuities, and other fixed or determinable annual or periodical gains, profits, and income, to the extent the amount so received is from sources within the United States and is not effectively connected with the conduct of a trade or business within the United States.

Section 871(f) of the Code provides an exclusion from gross income for amounts received as an annuity from certain qualified pension plans.

Section 861(a)(3) of the Code provides that compensation for labor or personal services performed in the United States shall be treated as income from sources within the United States and section 862(a)(3) provides that compensation for labor or personal services performed without the United States shall be treated as income from sources without the United States.

Section 1.861-4(a) of the Income Tax Regulations provides that gross income from sources within the United States includes compensation for labor or personal services performed in the United States regardless of the residence of the payer, the place where the contract for service was made, or the place of payment.

Section 1.861-4(b) (1) (i) of the Regulations provides, with respect to taxable years beginning after December 31, 1975, that when labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

Section 1.864-4(c)(6)(ii) of the Regulations provides that pensions and retirement pay received by a nonresident alien individual attributable to personal services that constitute engaging in a trade or business in the United States constitute income that is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if the individual is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

Continued on next page

Law and Analysis (continued)

Section 1441(a) of the Code provides, in general, for the withholding of tax at a 30% rate on certain income from sources within the United States of nonresident alien individuals.

Section 1441(b) of the Code lists salaries, wages, annuities or other fixed or determinable periodical gains as items of income subject to the withholding of tax under section 1441(a).

Employer contributions to an annuity or pension plan represent compensation for personal services. *See* Rev. Rul*. 56-82, 1956-1 C.B. 59*. An employer's contributions to a pension plan with respect to wages earned abroad by a taxpayer is compensation for labor or personal services performed without the United States and are treated as derived from sources without the United States. *See* Rev. Rul. 72-149, 1972-1 C.B. 218.

S. Rep. No. *1707*, 89th Cong., 2nd Sess. (1966), 1966-2 C.B. 1059 at 1077, relating to section 871(f) of the Code, states that in cases to which 871(f) does not apply, a nonresident alien receiving pension income from a plan located in the United States is subject to United States tax on the interest portion of the pension income notwithstanding that employer contributions are wholly in respect of services performed abroad. *See also* Rev. Rul. 56 125, 1956-1 C.B. 627, which indicates that distributions to a citizen of the United States from a qualified pension trust are income from sources within the United States, to the extent such distributions represent earnings and accretions to contributions of either the employer or the employee.

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Holdings

1. Because A is a nonresident alien who is not engaged in a trade or business in the United States in 1979, the year A received the pension payments under consideration, the portion of the payments that is from United States sources is not effectively connected with the conduct of a trade or business within the United States and therefore is subject to the imposition of tax under section 871(a) (1) (A) of the Code, and to the withholding of tax under section 1441(a).

2.a) The part of each pension payment received by A from X's United States pension plan that represents the earnings of the pension plan is income from sources within the United States.

b) The part of each payment received by A under X's plan that is attributable to X's contributions with respect to services rendered by A outside the United States is income from foreign sources and the part received by A under X's plan attributable to X's contributions with respect to services rendered by A within the United States is income from sources within the United States.

For a related issue involving pension payments to a citizen of the United States, see Rev. Rul. 79-389, page 281, this Bulletin.

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Handout 4-B – *Taxation of Nonresident Aliens*

U.S. Source Income

Engaged in a U.S. Trade or Business During the Tax Year			
Income Source Rates	**How Connected**	**Expenses**	**Tax**
Business	Effectively Connected	Allowed	Graduated
Personal Services	Effectively Connected	Allowed	Graduated
Pensions	Effectively Connected		Graduated
Partnership (partnership engaged in business in U.S.)	Effectively Connected		Graduated
Beneficiary of an Estate or Trust (entity engaged in business in U.S.	Effectively Connected		Graduated
Rental Property	Effectively Connected and Election made	Allowed	Graduated
All Gains on U.S. Real Property	Effectively Connected	Allowed	Graduated
U.S. Personal Property Gains	Effectively Connected	Allowed	Graduated
Investments	If Effectively Connected If not Effectively 30% or Connected Lower Tax Treaty	Allowed	Graduated

Continued on next page

NOT Engaged in a U.S. Trade or Business During the Tax Year			
Income Source Rates	**How Connected**	**Expenses**	**Tax**
Pensions (paid because of personal services performed in a prior tax year)	Effectively Connected		Graduated
Investments	Not Effectively Connected		30% or Lower Tax Treaty
Personal Services	Not Effectively Connected		30% or Lower Tax Treaty
Rental Property	Not Effectively Connected		30% or Lower Tax Treaty
Gains on U.S. Personal Property (if NRA in U.S. 183 days or more)	Not Effectively Connected		30% or Lower Tax Treaty

Foreign Source Income

Engaged in U.S. Trade or Business During Tax Year

Generally, **not** taxable, but may be taxable if effectively connected with U.S. business and NRA has fixed place of business in the U.S. **and** income is attributable to usual business practices. This includes income from:

1. rents, royalties or gains/losses from intangible property located outside the U.S.
2. dividends, interest and gain/loss from the sale of stocks, notes or bonds derived in the conduct of a banking or financial business in the U.S.
3. income, gain/loss from the sale of business inventory or stock sold in trade outside the U.S.

Not taxable for following types of income:

If not engaged in a U.S. trade or business, no foreign source income is taxable in the U.S.

Glossary

Effectively Connected Income	Income, other than certain investment income, earned from sources within the United States while engaged in a U.S. trade or business.
Green Card	An alien registration card — Form 551, *Permanent Resident Card* (or Form 151, *Alien Registration Receipt Card*).
Not Effectively Connected Income	Income that does not meet the criteria to be effectively connected.

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International Technical Training

Chapter 4

Taxation of Resident Aliens and Dual-Status Aliens

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • Pencils/Pens • Highlighters
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by Instructor) • Flipcharts and markers

Overview

Introduction

Our last lesson covered taxation of nonresident aliens. This lesson will cover the taxation of the two types of resident aliens – resident aliens and dual-status aliens.

Instructor Notes

By way of review: What are the tests for determining U.S. residency? Which IRC section discusses the tests?

1. Green card and substantial presence tests
2. IRC § 7701

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and PowerPoint slides.

Objectives

At the end of this lesson, the student will be able to:

- Determine the correctness of a resident alien tax return.
- Correctly compute tax for a dual-status alien.

Continued on next page

Contents

This chapter contains the following topics:

Taxation of Resident Aliens

Except for a few special situations, resident aliens are subject to tax in exactly the same manner as U.S. citizens. They are taxed on worldwide income, and they use Form 1040 and all its schedules to report their income, just as U.S. citizens. In fact, from just looking at the return, it is impossible to tell whether a U.S. citizen or a resident alien has filed Form 1040.

You will recall from our earlier lesson on alien status that the nonresident alien, married to a U.S. citizen or resident alien, may make the election under IRC § 6013(g) to be taxed as a resident, thereby permitting a joint return for the year.

An important point to remember is that once the taxpayers make this election, they must report worldwide income of both spouses on the U.S. return. Since a nonresident alien would not normally report worldwide income to the U.S., it may not be to their advantage to make the election. The election is advantageous when the U.S. citizen or resident alien spouse is the wage earner and the nonresident spouse has little or no separate income. If the nonresident spouse has considerable income, the advantages of the joint tax rates may be outweighed by the amount of additional income that would have to be reported on the tax return.

Reading Assignment

Read IRC §§ 2(b)(2) and 2(b)(3).

Continued on next page

Head of Household – Nonresident Alien Spouse

A U.S. citizen or resident alien--married to a nonresident alien who does not make the election under IRC § 6013(g) and does not file a joint return--may be entitled to file as Head of Household. This special provision is available only to U.S. citizens and residents, but not to nonresident alien or dual-status taxpayers.

The taxpayer must be a resident alien for the entire year and maintain a home for himself and a qualifying child. A taxpayer meeting these conditions will be considered “unmarried” for purposes of the Head of Household filing status.

The nonresident alien spouse alone cannot qualify the taxpayer for this exception. A spouse cannot be a qualifying member of the household under the rules for Head of Household.

Note on Exemption: A taxpayer in the situation described above may claim an exemption for the nonresident alien spouse even if the spouse has never set foot in the U.S. A spouse's exemption is granted by virtue of IRC § 151(b) rather than under IRC § 151(e) that governs exemptions for dependents. To be eligible for the exemption the nonresident spouse cannot have any U.S. source income and cannot have been claimed as a dependent by another taxpayer.

Instructor Notes

Ask the students to give an example of when the rules of Head of Household do not apply.

The nonresident alien spouse alone cannot qualify the taxpayer for this exception, since a spouse cannot be a qualifying member of the household under the rules for Head of Household.

Resident Alien May Leave the U.S. Temporarily	Aliens who have acquired residence in the United States and who leave the U.S. temporarily may retain their status as residents until they take some definite action to abandon their U.S. residence.

Taxation of Dual-Status Aliens

A dual-status taxpayer is one who has the status of both a resident and nonresident alien during the same tax year. Dual-status does not refer to citizenship, only to residence status in the United States. The most common dual-status tax years are the years of arrival and departure. In essence, he is treated as two taxpayers in one year, both a resident alien and nonresident alien. For this reason, a dual-status alien is required to submit two forms constituting one return: Form 1040 and 1040NR. Form 1040 covers the period of the year during which he was a resident and contains income from worldwide sources during this time. During the portion of the year he was a nonresident alien, he is required to report income only from U.S. sources on Form 1040NR.

Reading Assignment

Read Treas. Reg. § 1.871-13(a).

Dual-status aliens are subject to the following restrictions:

1. Standard deduction – Cannot use the standard deduction allowed on Form 1040; however, can itemize any allowable deductions.
2. Exemptions – Deduction for the exemptions of spouse and allowable dependents cannot be more than the taxable income for the period he/she is a resident alien.
3. Head of household – Cannot use the head of household Tax Table column or Tax Rate schedule.
4. Joint return – Cannot file a joint return unless an election has been made under IRC § 6013(g) or (h).
5. Tax rates – If married, cannot use the Tax Table column or Tax Rate schedule for married filing jointly or single. Must use the married filing separate Tax Table column or Tax Rate schedule.

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Taxation of Dual-Status Aliens, Continued

It is important to remember that dual-status taxpayers moving to the U.S. are permitted to deduct moving expenses on Form 3903. However, since the U.S. ceases to tax such aliens on their departure, the cost of their move back home is not deductible.

Consider the following example of a dual-status taxpayer's income from investment sources continuing after he departs from the U.S.

- Suppose he has U.S.-source interest and dividends from stock for the entire year of departure.
- The portion of interest and dividends earned while in resident status is reported on Form 1040, exactly as for a U.S. citizen.
- When he becomes a nonresident alien, any interest from a savings account which qualifies under the exception rules for nonresident aliens is tax-free.
- The dividends which were added to the taxpayer's other income on Form 1040 while he was a resident alien are now taxed at 30% (or the lower tax treaty rate) on Form 1040NR.

Instructor Notes

Another reminder:

Although a dual-status alien is not allowed to take the standard deduction, he is entitled to the same itemized deductions available to a U.S. citizen during the portion of the year he was a resident.

Summary

1. Resident aliens are taxed in the same manner as U.S. citizens.
2. A dual-status alien is one who is a resident alien for part of the tax year and a nonresident alien for part of that same tax year.
3. A dual-status individual must:
   a. File both Form 1040 for the period of time he was a resident and Form 1040NR for the time he was a nonresident;
   b. Not take advantage of the standard deduction;
   c. Not use the Head of Household filing status;
   d. Not file a joint return unless the IRC § 6013(g) or (h) election remains in effect;
   e. Use the Married Filing Separately filing status if married if no IRC § 6013 election is made;
   f. Not claim personal exemptions in excess of taxable income while a resident alien.

Instructor Notes

Ask the students:

1. What are the restrictions for dual-status aliens?

   Answer: a-f above.

2. If a nonresident alien was in the U.S. for a portion of the year, what form is he required to complete?

   Answer: Form 1040NR.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

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Class Exercises

Instructor Notes

Allow 10-15 minutes for the students to work the following problem. Then go through the answers working the solution on the whiteboard.

Exercise 1

Hilary, a single alien, and her daughter, Heather, arrived in the U.S. in 1995. They lived in Maryland. On July 1, 2008, Hilary left her job and they returned to India. Her income and expenses for 2008 are as follows:

Income	
U.S. W-2	$15,000
Indian wages (in $)	8,000
Interest income at a fixed-rate from a U.S. bank (12 months)	500
British Airways dividends (in $) (Stock purchased 8/27/01)	50
IBM dividends (paid quarterly) (Stock purchased 9/1/91)	120
Expenses	
Moving	7,000
State income tax	1,500
Contributions — U.S. Episcopalian Church	130
Church of England	200
School uniforms for Heather	125

The exemption amount in 2008 is $3,500. India has a tax treaty with the U.S. The treaty rate for dividends paid by U.S. corporations is 25%.

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Exercise 1 (continued)

Determine the following:

a. What is her alien status?
Answer: Dual status

b. What is her filing status?
Answer: Single

c. How many exemptions may she take?
Answer: 2

d. Compute her tax for the year
Answer:

U.S. Residency Period – Form 1040	
Income: Wages	$15,000
Interest	250
Dividends	60
Total Income/AGI	$15,310
Itemized Deductions: State tax	$1,500
Contributions	130
Total	$1,630
Subtotal	$13,680
Exemptions	7,000
Taxable income	6,680
Tax	668

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Exercise 1 (continued)

Foreign Residency Period Form 1040NR

Not effectively connected income:	IBM dividends $60 Taxed at 25% Tax $15.00
Effectively connected income:	None

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Glossary

Dual-Resident Taxpayer	An individual who is a resident of both countries according to each country's tax laws.
Dual-Status Taxpayer	An individual who is both a nonresident and a resident alien in the same tax year.

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International Technical Training

Chapter 5

Tax Treaties

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 2 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • Pencils/Pens • Highlighters
Participant References	• Publication 901 • Publication 54 • Publication 515 • Publication 581
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides • Flipcharts and markers • Transparency markers • Overhead projector

Overview

Introduction

You have already learned some important facts about tax treaties.

The United States has income tax treaties with a number of foreign countries. Under these tax treaties, residents of foreign countries, and sometimes even U.S. residents, may be subject to tax at a reduced rate, or may be exempt from U.S. income tax on certain items of income received from sources within the United States. These reduced tax rates and exemptions vary by country and the character of the specific item of income.

If you are auditing a nonresident alien who is claiming a reduced rate or exemption from tax under an income tax treaty, you must confirm that:

1. there is such a treaty;
2. the treaty provides for the benefits claimed; and
3. the nonresident alien claiming benefits is a resident of the treaty country.

If these baseline requirements are not met, the taxpayer must pay tax on the income in the same manner and at the same rates as shown in the instructions for Form 1040NR. While Publications 54, 515, 519, and 901 provide some information about U.S. tax treaties, international examiners must be able to research a particular income tax treaty to determine whether and how a category of income should be taxed.

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and PowerPoint slides.

Continued on next page

Objectives

At the end of this lesson, the student will be able to:

- Find the correct tax treaty and tax treaty article.
- Research the treaty article to find the correct answer.

Contents

This lesson covers the following topics:

What Is a Tax Treaty?

A treaty is a formal agreement made through diplomatic negotiations between two or more nations. Treaties have been entered into to end wars, establish alliances, and promote trade between nations. While our concern is primarily with income tax treaties, it is important to note that there are also estate tax treaties, gift tax treaties, and combined estate and gift tax treaties. The terms “tax treaty” and “tax convention” are used interchangeably.

The purpose of a tax treaty is usually twofold: the avoidance of double taxation and fiscal evasion. Double taxation occurs when two countries tax the same income. For example, you know that the United States taxes its citizens and residents on their worldwide income. As a result, a U.S. citizen who is a resident of Germany and who derives royalty income from films shown in the United States might be subject to tax on that income in both countries: in the United States, because the individual is a U.S. citizen with royalties from U.S. sources, and in Germany, because the individual is a German resident. The tax treaty between Germany and the United States eliminates this problem by making royalties solely taxable in the country of residence.

The importance of a tax treaty cannot be overemphasized. The U.S. Constitution in Article VI, Clause 2, declares a treaty to be “the supreme law of the land”. Code section 7852(d)(1) provides that for purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status. In other words, the provisions of the Internal Revenue Code and tax treaties are equal, and courts will try to read them in harmony. If there is a conflict between the two, the provision that was enacted later in time generally controls.

Purpose and Benefits of Tax Treaties

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules on which country has the jurisdiction to tax a particular item of income or a particular taxpayer; the method by which each country will allow its residents a credit or deduction for taxes paid to the other country; the qualifications a taxpayer must meet to receive treaty benefits; and, in the event that there is a disagreement between a taxpayer and country, or the parties to the treaty, a method for dispute resolution. These rules are intended to reduce the potential for dispute between countries over taxing jurisdiction, and ensure that taxpayers are not subject to tax in two countries.

One of the primary functions of a tax treaty is to provide certainty to taxpayers with respect to the threshold question of whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of activity that a resident of one country must engage in within the other country before the latter may tax any resulting income. In general terms, tax treaties provide that if a resident of one country carries on business in the other country, and that business activity is continuous and substantial, the country in which the activities occur will have jurisdiction to tax the income attributable to those activities. In cases where the operations are relatively minor, the home country retains the sole jurisdiction to tax its residents. In the absence of a tax treaty, a U.S. company operating a branch or division, or providing services in another country, might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid or accrued, there remains the potential for double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

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Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for determining the residence of a taxpayer that otherwise would be a resident of both countries. Second, with respect to each category of income, the treaty assigns the “primary” right to tax to one country (usually, but not always, the country in which the income arises (e.g., the “source” country)), and the “residual” right to tax to the other country (usually, but not always, the taxpayer’s country of residence). Third, the treaty may provide rules for determining which country will be treated as the source country for each category of income. Finally, the treaty establishes limits on the amount of tax that the source country can impose on each category of income, and obligates the residence country to eliminate double taxation that would otherwise arise from the exercise of concurrent taxing jurisdiction.

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Exercises

1. What is the purpose of a treaty?

   Answer: The purpose of a treaty is usually twofold. A treaty seeks the avoidance of double taxation and fiscal evasion.

2. Code vs. treaty – which takes precedence?

   Answer: Neither – the two are equal. If a different outcome would be reached by applying the provisions of a treaty or the Code to the same situation, the later-in-time provision controls.

3. Name the four types of tax treaties.

   Answer:
   1. Income tax treaties
   2. Estate tax treaties
   3. Gift tax treaties
   4. Combined estate and gift tax treaties

4. When does a treaty take effect?

   Answer: When both countries have ratified the treaty.

How a Treaty Is Made

The Office of the International Tax Counsel in the Department of the Treasury has the responsibility to negotiate tax treaties. After a treaty is drafted, it is signed by diplomatic agents of each country. The treaty is then sent to the White House for signature by the President. A letter of transmittal is sent to the Senate requesting approval of the Senate to ratification by the President.

The treaty is referred by the Senate to the Committee on Foreign Relations, which then conducts treaty hearings. After the Committee's deliberations, it may report on the Senate floor with the recommendation that the treaty be approved as negotiated, or that the Senate approve the treaty with certain amendments, reservations, or understandings. The Committee may also decline to report the treaty favorably.

Following Committee action, the treaty is reported to the full Senate, which must advise and consent to the treaty's ratification by a vote of two-thirds of the members of the Senate that are present. If the treaty is approved without reservation or amendment, the President may then exchange instruments of ratification with the foreign government (assuming the foreign government has also completed its internal procedures to ratify the treaty). If the Senate has approved the treaty with a reservation or amendment, it may be necessary to renegotiate portions of the treaty before the foreign country will ratify. If the renegotiation is limited in scope, it will ordinarily be done in the form of a protocol by a two-thirds vote as if it were a separate treaty.

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How a Treaty Is Made, Continued

Example 1

On November 26, 2002, the Second Additional Protocol to the U.S.-Mexico treaty was signed in Mexico City. It amends the Convention and Protocol between the United States and Mexico signed September 18, 2002. On February 25, 2003, the Second Additional Protocol was received by the Senate. On March 3, 2003, Senate Committee hearings took place. On March 13, 2003, the Senate and President ratified the Second Additional Protocol. Also on that date, the President of Mexico ratified the Second Additional Protocol.

On July 3, 2003, instruments of ratification were exchanged, and the Second Additional Protocol entered into force effective September 1, 2003, with respect to dividends, and for taxable periods beginning on or after January 1, 2004, for other provisions.

Format of a Treaty

The U.S., OECD, and U.N. model treaties contain numbered articles that address a specific subject. In general, each numbered article addresses the same subject regardless of which treaty is being researched. However, this is not always the case.

For example, Article 4 of the U.S. model treaty defines “resident” for purposes of applying the treaty. Articles 4 of a U.S. tax treaty with any other country will also most likely address the subject of residency. This simplifies treaty research.

Exhibit 1 below illustrates the format of the U.S. model tax treaty:

CONVENTION BETWEEN
THE GOVERNMENT OF THE UNITED STATES OF AMERICA
AND THE GOVERNMENT OF ____________
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION
WITH RESPECT TO TAXES ON INCOME

The United States of America and _________ desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income have agreed as follows:

Article 1 (General Scope)
Defines the general scope of the treaty. Usually contains the saving clause (but this may also be found in Article 4 or elsewhere), which states that the treaty does not affect the taxation by a country of its residents (as determined by the treaty) and its citizens. If Article 1 contains the saving clause, it will also provide exceptions where the saving clause will not apply.

Article 2 (Taxes Covered)
Defines the taxes covered by the treaty. Generally, these will be income taxes.

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Article 3 (General Definitions)
Defines certain, but not all, of the terms used in the treaty. Provides that an undefined term has the meaning it has under the law of the country applying the treaty.

Article 4 (Resident)
Defines residency for purposes of the treaty.

Article 5 (Permanent Establishment)
Defines what constitutes a permanent establishment.

Article 6 (Income from Real Property)
Governs the taxation of income derived from real or immovable property.

Article 7 (Business Profits)
Sets forth provisions to determine which country has jurisdiction to tax business profits, and how such profits are to be calculated. Governs the taxation of income from independent personal services, which is defined to be included in business profits.

Article 8 (Shipping and Air Transport)
Governs the taxation of profits of an enterprise from the operation of ships and aircraft in international traffic.

Article 9 (Associated Enterprises)
Governs the assignment of income between related entities where one entity is located in the United States, and the other is located in the treaty partner's country.

Article 10 (Dividends)
Governs the taxation of dividends.

Article 11 (Interest)
Governs the taxation of interest.

Article 12 (Royalties)
Governs the taxation of royalties.

Continued on next page

Article 13 (Gains)
Governs the taxation of gains from the sale of real property.

Article 14 (Income From Employment)
Governs the taxation of income from employment.

Article 15 (Directors' Fees)
Governs the taxation of directors' fees.

Article 16 (Entertainers and Sportsmen)
Governs the taxation of income derived by entertainers and sportsmen.

Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support)
Governs the taxation of pensions, social security, annuities, alimony, and child support.

Article 18 (Pension Funds)
Governs the taxation of income derived from a pension fund.

Article 19 (Government Service)
Governs the taxation of wage and pension income from services rendered to a government.

Article 20 (Students and Trainees)
Grants certain tax exemptions under very limited circumstances to students and trainees.

Article 21 (Other Income)
Governs the taxation of income that is not covered by other articles of the treaty. Generally, but not always, provides for residence-based taxation.

Article 22 (Limitation on Benefits)
Sets forth additional requirements that must be met in order for a resident to be entitled to treaty benefits.

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Article 23 (Relief from Double Taxation)
Sets forth rules to determine how each country will relieve the double taxation of its residents. This can be achieved by deduction or credit.

Article 24 (Non-discrimination)
Prohibits a country from subjecting nationals of the other country to taxation that is more burdensome than the taxation to which their nationals in the same circumstances are subjected.

Articles 25 (Mutual Agreement Procedure)
Provides a mechanism for relief in cases where a resident is not being taxed in accordance with the treaty.

Article 26 (Exchange of Information and Administrative Assistance)
Provides for the exchange of certain information between the parties to the treaty in order to carry out the provisions of the treaty, or the parties' tax law.

Article 27 (Members of Diplomatic Missions and Consular Posts)
Provides that the treaty will not affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Article 28 (Entry Into Force)
Provides an effective date for the treaty.

Article 29 (Termination)
Provides a procedure by which to terminate a treaty.

Note: Some treaties do not contain every one of the above articles, while others contain additional articles. This will affect the numbering of the articles to some extent. In particular, older treaties have Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services). Modern treaty practice is to include independent personal services in the business profits category, and have a new Article 14 (Income from Employment).

Continued on next page

Exercise 5

Using the above tax treaty format, identify which article applies to the following types of income:

a. Rental Income

Answer: Article 6 of the U.S. Model treaty

b. Interest Income

Answer: Article 11 of the U.S. Model treaty

c. Wage Income

Answer: Article 14 of the U.S. Model treaty

d. Student and Trainees

Answer: Article 20 of the U.S. Model treaty

The Geographical Scope of Tax Treaties

Tax treaties differ in the geographical scope that they cover. Often, the geographical scope will be defined in Article 3 (General Definitions). However, under international law, if a new country is formed out of a country that is a party to treaties that are in force at the time of the new country's formation, the newly formed country will be covered by those treaties until the treaties are renegotiated or terminated.

Treaties with particular countries also cover or have been extended to cover certain territories of a treaty nation. If such territory later becomes independent, the treaty remains in effect with the new nation unless the treaty is terminated or renegotiated. Thus, if neither the United States nor the other country takes any action, the treaty will remain in effect.

Example 2

Barbados, a former territory of the United Kingdom, became an independent state on November 6, 1966. A treaty was signed between Barbados and the United States in 1984.

Example 3

Czechoslovakia ceased to exist at midnight on December 31, 1992, and was succeeded by two separate and independent states: the Czech Republic, and the Slovak Republic. Both countries signed tax treaties with the United States in 1993.

The complete texts of tax treaties may be found on the IRS website at www.irs.gov. Use the "Search" feature to locate "INCOME TAX TREATIES". Newer treaties may not be on the IRS website. These can be found on the Department of Treasury's website.

Continued on next page

Gambling Winnings and Tax Treaties

U.S. source gambling income derived by residents (as defined by the applicable treaty) of the following countries is not taxable by the United States: Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Netherlands, Russian Federation, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Tunisia, Turkey, Ukraine, and the United Kingdom.

Claimants must give you a Form W-8BEN (with a valid U.S. TIN) to claim treaty benefits on gambling income that is not effectively connected with a U.S. trade or business.

U.S. source gambling winnings derived by Canadian residents are subject to 30% withholding on a gross basis. However, under Article XXII of the Canada-U.S. income tax treaty, Canadian residents may deduct their losses from wagering transactions made in the United States against such gain to the extent those losses would be deductible if incurred by a U.S. taxpayer. Canadian residents should file a Form 1040NR to obtain a refund of U.S. withholding taxes.

Refer to T.D. 8977 and Temp. Treas. Reg. § 1.1441-6T for more information.

Non-Discrimination and Savings Clauses

Every treaty contains a non-discrimination clause. This clause provides that nationals of one contracting state residing within the other contracting state shall not be subjected to the payment of more burdensome taxes than the nationals of that other contracting state in similar circumstances. For example, the nondiscrimination clause under paragraph 1 of Article 25 of the Canada-U.S. tax treaty provides that nationals of Canada residing in the United States may not be subjected to more burdensome taxes than U.S. nationals in similar circumstances.

U.S. tax treaties also contain a saving clause, usually in Article 1 or Article 4, that provides that a contracting state reserves the right to tax its citizens and residents as if the tax treaty had not entered into force. Some saving clauses only apply to U.S. residents and citizens, but those in modern treaties are generally bilateral. The treaty will list any exceptions to the saving clause, which are important to note.

Example 4

Oliver is a citizen of the United States and a resident of Luxembourg. Oliver travels to the United States for one year to teach at a university. Under Article 21 of the U.S.-Luxembourg tax treaty, Oliver's salary from teaching would be exempt from U.S. income tax. However, under the saving clause of Article 1(3), the United States has reserved the right to tax its citizens as if the treaty had not entered into force. Therefore, Oliver must pay U.S. income tax on his teaching income.

Instructor Notes

Display on a PowerPoint slide or transparency.

Continued on next page

Non-Discrimination and Savings Clauses, Continued

1. Format of a tax treaty.
   a) Highlights
   b) Synopsis
   c) Treaty
   d) Protocols
   e) Regulations
   f) Reports

2. What are the non-discrimination and saving clauses? How do they affect U.S. tax law?

a. A **non-discrimination** clause provides that a national of one contracting state who is a resident of the other contracting state will not be subjected to more burdensome taxes than a national of that other contracting state in similar circumstances.

b. A **saving** clause provides that a contracting state may tax its citizens and residents as though the treaty had not entered into force.

Competent Authority Claims

As stated earlier, one of the primary purposes of tax treaties is to avoid double taxation. Every tax treaty therefore provides that a resident of a contracting state who believes his or her income was taxed in a manner not in accordance with the treaty may appeal to the competent authority in his or her state of residence.

The competent authority for the U.S. government is the IRS Commissioner. However, the Tax Treaty Division of LMSB coordinates the processing of all competent authority claims. These often involve correspondence between the Commissioner and the competent authority of the foreign government. Taxpayer requests competent authority assistance in accordance with the guidelines set forth in Rev. Proc. 2006-54. Incoming correspondence from the foreign government concerning a particular claim should immediately be referred to Tax Treaty Division.

In addition to a timely filed request for assistance, the taxpayer may take the following measures to protect the right to the review of his or her case by competent authorities:

1. Timely file a protective claim for credit or refund of U.S. taxes on Form 1040X to preserve the right to a foreign tax credit if the taxpayer does not qualify for the treaty benefit in question.
2. Take appropriate action under the foreign country's procedures to avoid the lapse or termination of the right of appeal under the foreign country's income tax law.

Class Exercises

Using only Publication 901, answer the following questions:

a. Karen, a citizen of Denmark, comes into your office. She is in the United States to teach for one academic year at a U.S. university. Will her income from the university be taxed by the United States?

Answer: Teaching income is exempt.

Authority for Answer: Article XIV.

b. Blanche, a U.S. citizen who is a resident of Australia, receives a pension from her former employer in the United States. Is her pension taxed by the United States?

Answer: Article 18 states that a pension is only taxable in the state of residence.

Article 1 states that the United States may tax its citizens as though the treaty had not entered into force.

Blanche's pension would not be exempt from U.S. tax.

Authority for answer: Article 1.

Continued on next page

c. Susan, a national of Japan, arrived in the United States on June 20, 2006, to pursue a full-time course of study at a U.S. university. She was in the United States on an F-1 visa. She left the United States on May 31, 2008. Determine whether her income is excludable from U.S. tax under a treaty article if:

1. Her maintenance and educational expenses were paid by a gift or grant from her home university, the amount received in 2007 being $2,400.

Answer: Under Article 19, the income would be exempt.

2. She received compensation for personal services from the U.S. University not in excess of $1,800 in 2007.

Answer: Under Article 14, the income would be taxable.

3. She received compensation for personal services paid by a resident of her home country of $2,400 for 2008.

Answer: Under Article 14, the income would be exempt from tax because she was in the United States for less than 183 days (if she was a resident of Japan in 2008).

Determining If a Tax Treaty Is Present

Instructor Notes

Ask the students what sort of tax returns might contain tax treaty issues.

Possible answers are Forms 1040NR and 1040NR-EZ.

Make sure the students realize that tax treaty issues can appear on ANY sort of tax return, including Forms 1040, 1040A, and especially 1040X, *Amended Individual Tax Return*, in addition to Form 1040NR.

Internal Revenue Code section 6114(a) generally requires disclosure of any position taken on a tax return that is based on a tax treaty provision.

Treaty-Based Return positions

IRC § 6114(a) In General. —Each taxpayer who, with respect to any tax imposed by this title, takes the position that a treaty of the United States overrules (or otherwise modifies) an internal revenue law of the United States shall disclose (in such manner as the Secretary may prescribe) such position

1. on the return of tax for such tax (or any statement attached to such return), or
2. if no return of tax is required to be filed, in such form as the Secretary may prescribe.

Form 8833 is used for this purpose – see Exhibit 7-1.

Analyzing Tax Returns for Tax Treaty Issues

In addition to the presence of Form 8833, if a taxpayer files Form 1040NR, other tax treaty issues may be present.

Refer students to a copy of the Form 1040NR that they received with Chapter 4, *Nonresident Aliens*. Go over Form 1040NR and locate where tax treaty information may be disclosed.

Instructor Notes

1. Ask the students what sort of tax returns may contain tax treaty issues.

   Possible Answers are Forms 1040NR and 1040NR-EZ.

   Make sure the students realize that tax treaty issues can appear on ANY sort of tax return, including Forms 1040, 1040A, and especially 1040X, *Amended Individual Tax Return*, in addition to Form 1040NR.

2. Ask the students to locate where on Form 1040NR tax treaty information may be present.

   Possible Answers include line 22, all of page 4, and items "M" and "I" on page 5.

Tax treaty issues are more difficult to identify if Form 8833 or Form 1040NR is not filed by the taxpayer.

Summary

1. A U.S. tax treaty is an agreement between the United States and another country for the purpose of avoiding international double taxation and preventing tax avoidance and evasion. The countries are referred to as “Contracting States”.
2. Treaty issues may be present on any sort of individual tax return, not just Form 1040NR.
3. The U.S. Model tax treaty consists of numbered articles that address a specific subject or type of income.
4. A protocol amends a tax treaty. If CCH shows that a protocol exists, it <u>*must*</u> be reviewed before making a determination.
5. The saving clause reserves to the United States the right to tax its citizens and residents as if the treaty did not exist.
6. The non-discrimination clause provides that a Contracting State may not subject nationals from the other Contracting State to more burdensome taxation than it imposes on its own nationals in similar circumstances.
7. A tax treaty may cover a nation’s territories in its geographic scope.
8. If a different outcome would be reached by applying the provisions of a treaty or the Code to the same situation, the later-in-time enacted provision controls.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

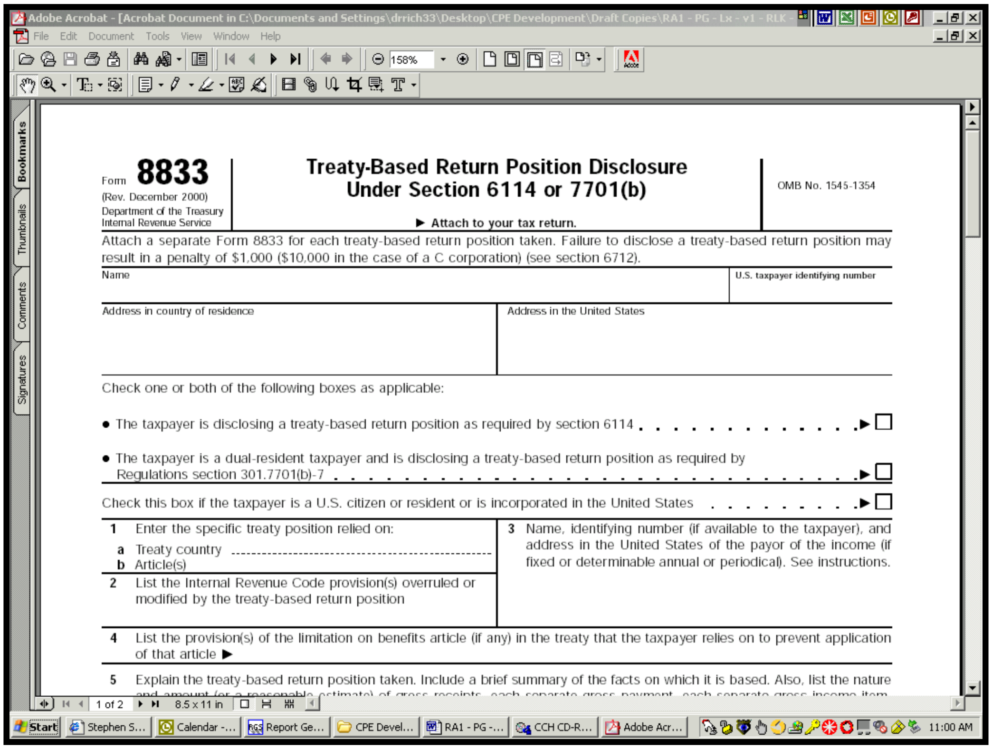
Glossary

Certificate of Compliance	A certificate received in anticipation of leaving the United States, either temporarily or permanently, indicating that tax obligations have been or will be met without incident (also called sailing permit, departure permit, tax clearance).
Competent Authority	The individual designated by the government of a treaty country to administer the operating provisions of its tax treaties, and to interpret and apply those treaties.
Contracting States	The two countries that are party to a treaty; all treaty articles are written in terms of the contracting state and the other contracting state.
Country of Residence: (Residence Country)	The taxpayer's country of residence for tax purposes; each treaty defines "residence" for that particular agreement.
Enters Into Force	Becomes a binding contract; occurs on the date the instruments of ratification are exchanged, or at a later time specified in the treaty.
Instruments of Ratification	Each country provides a document signifying ratification of the treaty by the appropriate governing body.
Memorandum of Understanding (MOU)	Supplemental to a treaty; presents agreed understandings as to the proper interpretation of certain provisions of the treaty.
Protocol	An amendment or supplement to a tax treaty.

Continued on next page

Resident	Generally, a resident of a contracting state is one who is liable to that state for tax on worldwide income. Factors used to determine if an individual would be treated as a resident may be domicile, residence, or citizenship. These factors vary in different treaties, but citizenship alone seldom establishes residence. A tax treaty definition of residency may override a determination of U.S. residency under the green card or substantial presence tests.
Treaty	A formal agreement made through diplomatic negotiations between two or more nations.
Treasury Department Technical Explanation	An “official guide” to a treaty that reflects the policies behind particular treaty provisions, as well as understandings reached with respect to the application and interpretation of the treaty.

Exhibit 5-1, *Form 8833*



Form **8833** (Rev. December 2000) Department of the Treasury Internal Revenue Service

Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)

► Attach to your tax return.

OMB No. 1545-1354

Attach a separate Form 8833 for each treaty-based return position taken. Failure to disclose a treaty-based return position may result in a penalty of $1,000 ($10,000 in the case of a C corporation) (see section 6712).

Name	U.S. taxpayer identifying number
Address in country of residence	Address in the United States

Check one or both of the following boxes as applicable:

- The taxpayer is disclosing a treaty-based return position as required by section 6114 . . . . ► ☐
- The taxpayer is a dual-resident taxpayer and is disclosing a treaty-based return position as required by Regulations section 301.7701(b)-7 . . . . ► ☐

Check this box if the taxpayer is a U.S. citizen or resident or is incorporated in the United States . . . . ► ☐

1 Enter the specific treaty position relied on:
a Treaty country
b Article(s)

2 List the Internal Revenue Code provision(s) overruled or modified by the treaty-based return position

3 Name, identifying number (if available to the taxpayer), and address in the United States of the payor of the income (if fixed or determinable annual or periodical). See instructions.

4 List the provision(s) of the limitation on benefits article (if any) in the treaty that the taxpayer relies on to prevent application of that article ►

5 Explain the treaty-based return position taken. Include a brief summary of the facts on which it is based. Also, list the nature

This form will generally be attached to returns completed by major accounting and tax preparation firms, particularly if the return is completed by an overseas-based office of such firm.

Form 8833 generally must be attached to the return of a taxpayer relying on a treaty to reduce or exempt U.S. tax. The taxpayer uses Form 8833 to report which treaty and article is being relied on for the taxpayer's return position. The examiner should always review the specific treaty the taxpayer is citing, and its accompanying Technical Explanation for guidance.

Many domestic accountants and tax preparers do not include this form and most self-prepared returns will not contain the form. Tax treaty issues will be discovered only upon closer inspection and analysis of the tax return.

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International Technical Training

Chapter 6

IRC § 911 Introduction and Qualifications

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 5 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide • Form 2555
Participant Materials	• Participant Guide • Pencils/Pens • Highlighters
Participant References	• Form 2555 • CCH Disk
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by Instructor) • Flipcharts and markers

Overview

Instructor Notes

Use the Form 2555 as a handout to the trainees to show them how the foreign earned income is calculated.

Show:

- Relationship between the foreign sourced income reported on the Form 2555 to the Wages and Schedule C Gross Profit reported Form 1040
- Computation of the base 911 exclusion and the housing amount.
- Reduction formula for expenses related to exempt income.

Introduction

Under IRC § 61, gross income includes items of income from any source and in any form. U.S. citizens and resident aliens are taxed on their worldwide income. However, under IRC § 911, referred to as the "911 exclusion" or "foreign earned income exclusion," qualified individuals may currently elect to exclude from gross income up to $87,600 of foreign earned income in 2008. This chapter will discuss various rules regarding the exclusion.

Continued on next page

Introduction (continued)

Here is an example showing the basic IRC § 911 exclusion –

Tom is a U.S. citizen who goes to Paris, France to work as an engineer. He lives and works in Paris from December 1, 2006 to June 30, 2008 and has his tax home there. He earns $155,700 per year and pays $33,712 in housing costs. If he qualifies under IRC § 911 as a bona fide resident for 2007, or meets the physical presence test which requires him to be in a foreign country for 330 days out of a 12-consecutive-month period, he may elect to exclude portions of his income and housing costs as follows:

Income earned in a foreign country		$155,700
Housing costs	$33,712	
Less base amount	($13,712)	
Allowable Housing Costs		($ 20,000)
Available for earned income exclusion		$135,700
Maximum 2007 exclusion allowed		($ 85,700)
Taxable earnings		$ 50,000

The relevant Code sections within IRC § 911 are:

- 911(a): Exclusions from Gross Income
  - Foreign Earned Income (FEI)
  - Housing Costs
- 911(b): FEI Definition and Limitations
- 911(c): Housing Costs
- 911(d): Definitions: Qualifying Individual
- 911(e): Election Requirements
- 911(f): Tax Computation

Continued on next page

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and PowerPoint slides.

Objectives

At the end of this lesson, the student will be able to:

- Determine who qualifies for the foreign earned income exclusion.
- Determine the qualifying periods for purposes of the foreign earned income exclusion.
- Determine the foreign earned income eligible for the foreign earned income exclusion.

Continued on next page

Contents

This lesson covers the following topics:

Requirements

In order for a taxpayer to claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the following requirements must all be satisfied.

1. The taxpayer's "tax home," as defined in IRC § 911, must be in a foreign country.
2. The taxpayer must have income earned in a foreign country.
3. The taxpayer must be one of the following:
    a. U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year,
    b. U.S. resident alien who is a citizen or national of a country with which the U.S. has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or

Key Point:

- Discuss how this affects taxpayer from non-treaty countries.

    c. U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

Note that if the taxpayer is a nonresident alien married to a U.S. citizen or resident alien, and both the taxpayer and their spouse choose to treat the taxpayer as a resident alien, then the taxpayer will be considered a resident alien for tax purposes (IRC §§ 6013(g) and (h)).

See Appendix 8-A for a flowchart illustrating the requirements.

Tax Home

Reading Assignment

Read Treas. Reg. § 1.911-2(b).

To qualify for the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the taxpayer's "tax home" must be in a foreign country throughout their period of bona fide residence or physical presence abroad.

"Tax home" is the general area of the taxpayer's main place of business, employment, or post of duty, regardless of the location of the taxpayer's family home. The tax home is the place where the taxpayer is permanently or indefinitely engaged to work as an employee or self-employed individual. The tax home is not necessarily the residence or domicile for tax purposes.

If the taxpayer does not have a regular or main place of business because of the nature of their work, their tax home may be the place where they regularly live. If the taxpayer has neither a regular or main place of business nor a place where they regularly live, they are considered a "wandering sojourner" or an itinerant, and their tax home is wherever they work.

A taxpayer is not considered to have a tax home in a foreign country for any period in which their abode is in the U.S. However, an abode is not necessarily in the U.S. while a taxpayer is temporarily in the U.S. Also, a taxpayer's abode is not necessarily in the U.S. merely because the taxpayer maintains a dwelling in the U.S., regardless of whether the taxpayer's spouse or dependents use the dwelling.

"Abode" has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. It does not mean the taxpayer's principal place of business. "Abode" has a domestic rather than a vocational meaning and does not mean the same as "tax home." The location of a taxpayer's abode often will depend on where they maintain their economic, family, and personal ties.

Continued on next page

Reading Assignment

Read:

- *Bujol v. Commissioner*, T.C. Memo 1987-230, *aff'd without published opinion*, 842 F.2d 328 (5th Cir. 1988).
- GLAM AM2009-003, Application of Foreign Earned Income Exclusion and the Combat Zone Exclusion to Civilian Contractors Working in Combat Zones.

Key Point:

- Discuss the difference between the military contractor situation and the oil field workers. How did the frequency of time spent in the U.S. make a difference in the conclusions?

Example 1

Kim lives and works in Santa Ana, California. Her tax home is Santa Ana.

George is a traveling salesman. His office is in Santa Fe, New Mexico but he is on the road about 11 out of every 12 months. He has a room in an apartment in Santa Fe, which he maintains all year. His tax home is Santa Fe.

Harry works for a carnival and travels from city to city all year. He only visits his hometown, Phoenix, Arizona, at Christmas. Harry's tax home is wherever the carnival happens to be.

Exercise 1

Dan is employed on an offshore oil rig in the territorial waters of Mexico and works a 28-day-on/28-day-off schedule. Dan returns to his family residence in the U.S. during his off periods. Can Dan claim a § 911 exclusion? Why or why not?

Answer: No. Dan may not claim a § 911 exclusion. Dan is considered to have a tax home in the U.S., not Mexico.

Continued on next page

Exercise 2

For several years, Thomas was a marketing executive with a producer of machine tools in Salisbury, Maryland. In November of last year, Thomas' employer transferred him to London, England for a minimum of 18 months to set up a sales operation for Europe. Before he left, Thomas distributed business cards showing his business and home addresses in London. Thomas kept ownership of his home in Maryland, but rented it to another family. Thomas placed his car in storage. In November of last year, Thomas moved his spouse, children, furniture, and family pets to a home his employer rented for him in London. Shortly after moving, Thomas leased a car and he and his spouse got British driving licenses. Thomas' entire family got library cards for the local public library. Thomas and his spouse opened bank accounts with the Bank of London. Where's is Thomas' tax home?

Answer: Thomas' abode is in London for the time he lived there. Thomas' tax home is in England.

Foreign Country

Foreign Country Defined

A “foreign country” is defined as any territory under the sovereignty of a government other than that of the U.S. It includes the airspace over any such territory (Treas. Reg. § 1.911-2(h)). It does not include a possession or territory of the U.S.

The term “United States” means all 50 states, the District of Columbia and the U.S. possessions and territories.

Reading Assignment

Read:

- *Arnett v. Commissioner*, 126 T.C. 89 (2006), *aff’d*, 473 F.3d 790 (7th Cir. 2007). In light of the Antarctic Treaty (December 1, 1959), Antarctica is a sovereignless region and not a foreign country.
- *Specking v. Commissioner*, 117 T.C. 95, *aff’d. sum. nom. Haessley v. Commissioner*, 68 Fed. Appx. 44 (9th Cir. 2003), *aff’d. sum. nom. Umback v. Commissioner,* 357 F.3d 1108 (10th Cir. 2003). Johnston Islands is an unincorporated U.S. possession and not a foreign country.

Key Point:

- Discuss the situation with the employees in Antarctica, the Johnston Island contractors, merchant seamen and airline pilots. Income earned inside the U.S., in or over international waters, or in U.S. possessions is not foreign earned income.

Continued on next page

Exercise 3

a. What is a foreign country?

Answer:

1. A foreign country is defined as any territory under the sovereignty of a government other than that of the U.S. It includes the airspace over any such territory (Treas. Reg. § 1.911-2(h));
2. The territorial waters of the foreign country (determined under U.S. law);
3. The seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which the foreign country has exclusive rights under international law to explore and exploit natural resources; and
4. It does not include a possession or territory of the U.S. The term “United States” means all 50 states, the District of Columbia and the U.S. possessions and territories.

b. How do you treat international water?

Answer: Read IRC §§ 863(d) and 911. Any income derived from a space or ocean activity, if derived by a U.S. person, shall be sourced in the U.S.

c. Explain “space” or “ocean activity”

Answer:

1. Any activity conducted in space.
2. Any activity conducted on or under water, not within the jurisdiction of a foreign country.

d. Under what circumstances is a U.S. taxpayer living overseas required to file?

Answer: A U.S. citizen has the same filing requirements outside of the U.S. as those living within the U.S. (IRC § 6012).

Continued on next page

Exercise 3

e. Topic for Discussion: Arnold works in Iraq for a subcontractor. He is not allowed to bring his family with him to Iraq. On his annual 30-day vacations each year, he returns home to his wife and children in Sacramento, California. Where is Arnold's abode?

Answer:

Bona Fide Residency Test

Reading Assignment

Read Treas. Reg. §§ 1.911-2(a) and 1.911-2(c).

The bona fide residence test is met if the taxpayer is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year. A taxpayer can use the bona fide residence test to qualify for the exclusions and the deduction only if they are either a:

- U.S. citizen; or
- U.S. resident alien who is a citizen or national of a country with which the U.S. has an income tax treaty in effect.

Key Points:

- What are the factors to be considered in making a determination of whether or not someone is a bona fide resident? Go through the different factors used by the courts and describe how one would make a determination.
- A taxpayer does not automatically acquire bona fide resident status merely by living in a foreign country or countries for one year. If a taxpayer goes to a foreign country to work on a project for a specified period of time, the taxpayer will not be regarded as a bona fide resident of that country merely because he worked there for one year or longer. Instead, there are a variety of factors to be considered in determining whether the bona fide residency test is met.

Continued on next page

- Distinguish Thomas' situation in Exercise 2 above from the situation of a tourist merely traveling around England, who has no intention of permanently staying but instead intends to return to the U.S. The determination of whether a taxpayer is, or is not, a bona fide resident of a foreign country depends on the facts and circumstances of each case. The taxpayer has the burden of proving, to the satisfaction of the Service, that they were indeed a bona fide resident for an uninterrupted period that included an entire tax year. *See, e.g., Howard J. Sochurek v. Commissioner*, 300 F.2d 34 (7th Cir. 1962), *rev'g and remanding*, 36 T.C. 131 (1961).
- Taxpayers sometimes make a statement to the authorities of a foreign country that they are not bona fide residents of that foreign country and the foreign authorities determine the taxpayers are not subject to the foreign income tax laws as a resident. Such taxpayers cannot then claim to be bona fide residents of the foreign country for purposes of the 911 exclusion on their U.S. tax return.

Note: The existence of a treaty or other agreement that exempts a taxpayer from taxation in that foreign country has been held to NOT be equivalent to the taxpayer making a statement that they are not subject to income taxes and is not dispositive, in and of itself, on the issue of residence.

To qualify for bona fide residence, a taxpayer must reside in a foreign country for an uninterrupted period that includes an <u>entire</u> tax year. For most taxpayers, this will be from January 1 to December 31. During this period, a taxpayer can leave the foreign country for brief or temporary trips back to the U.S. or elsewhere for vacation or business, as long as the taxpayer has a clear intention of returning from such trips, without unreasonable delay, to their foreign residence. *See Donald F. and Eleanore A. Dawson v. Commissioner*, 59 T.C. 264 (1972).

Continued on next page

Exercise 4

Robert arrived with his family in Hong Kong on November 1, 2007. His assignment is indefinite, and he intends to live there with his family until his company sends him to a new post. Robert immediately established a residence in Hong Kong. On April 1, 2008, Robert arrived in the U.S. to meet with his employer, leaving his family in Hong Kong. Robert returned to Hong Kong on May 1, 2008 and continued living there. When will Robert meet the bona fide residency test?

Answer: Robert will meet the bona fide residence test after his qualifying period ends on December 31, 2008, when he will have lived in Hong Kong for an entire tax year.

Once a taxpayer has established bona fide residence in a foreign country for an uninterrupted period that includes an entire tax year, he will qualify as a bona fide resident for the period starting with the date he actually began the residence and ending with the date he abandons the foreign residence. Thus, a taxpayer can qualify as a bona fide resident for an entire tax year plus portions of the prior and subsequent tax years.

Example 2

Jan establishes residence (and a tax home) in Lebanon on July 1, 2007. Her qualifying period ends December 31, 2008. Once Jan satisfies the requirement for bona fide residence, she may use foreign earned income beginning July 1, 2007 for purposes of the § 911 exclusion.

Exercise 5

Alex was a bona fide resident of England from March 1, 2006 through September 14, 2008. On September 15, 2008, he returned to the U.S. What period was Alex a bona fide resident of England?

Answer: Alex was a bona fide resident of England from March 1, 2006 through September 14, 2008.

Physical Presence Test

Reading Assignment

Read Treas. Reg. § 1.911-2(d).

The physical presence test is met if a taxpayer is physically present in a foreign country or countries 330 full days during a period of 12 consecutive months. The 330 days do not have to be consecutive. Any U.S. citizen or resident alien can use the physical presence test to qualify for the exclusions and the deduction.

The physical presence test is based only on how long the taxpayer stays in a foreign country or countries. Unlike the subjective bona fide residency test, the physical presence test is objective, and does not depend on the taxpayer's intentions.

To meet the physical presence test, a taxpayer must be physically present in a foreign country or countries for at least 330 full days during a 12-month period. Days spent abroad for any reason count, including vacation time. If the 330-day rule is not met because of unforeseen circumstances beyond the taxpayer's control, the physical presence test is not met. Certain limited exceptions exist. These will be discussed later.

A "full day" is a period of 24 consecutive hours, beginning at midnight.

Key Point:

- Discuss how an examiner can verify the number of U.S. days. What information can be requested? Remind the students that in cases where it is close, to carefully count the arrival and departure days since many taxpayers wrongly assume that partial days count as foreign.

Continued on next page

Example 3

Jean leaves New York and arrives in London at 7:00 a.m. on November 2, 2008. Since her first full day begins at midnight, her first full day outside the U.S. and in a foreign country is November 3, 2008.

When the taxpayer leaves the U.S. to go directly to a foreign country or when the taxpayer returns directly to the U.S. from a foreign country, the time spent on or over international waters does not count toward the 330-day total.

A taxpayer can move about from one place to another in a foreign country or to another foreign country without losing full days. But if any part of the travel is not within a foreign country or countries and takes 24 hours or more, full days will be lost.

If a taxpayer is in transit between two points outside the U.S. and is physically present in the U.S. for less than 24 hours, the taxpayer is not treated as present in the U.S. during the transit. Instead, the taxpayer will be treated as traveling over areas not within any foreign country.

Exercise 6

Shelly left the U.S. for the United Kingdom by air on June 10. She arrives in the United Kingdom at 9:00 a.m. on June 11. When is Shelly's first full day in the United Kingdom for purposes of the physical presence test?

Answer: Shelly's first full day in the United Kingdom for purposes of the physical presence test is June 12.

Exercise 7

John left the U.S. by air at 9:30 a.m. on June 10 to travel to Kenya. His flight passed over western Africa at 11:00 p.m. on June 10 and arrived in Kenya at 12:30 a.m. on June 11. When is his first full day in Kenya for purposes of the physical presence test?

Answer: John's first full day in Kenya for purposes of the physical presence test is June 11.

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Exercise 8

Teresa left Norway by ship at 10:00 p.m. on July 6, headed out to international waters and arrived in Portugal at 6:00 a.m. on July 8. Do any days count as not being full days for purposes of the physical presence test?

Answer: July 6, 7, 8 are not counted as full days for purposes of the physical presence test. Teresa was not within a foreign country or countries and the trip took more than 24 hours.

Physical Presence – 12 Month Period

Four rules exist for figuring the 12-month period:

1. The 12-month period can begin with any day of the month. It ends the day before the same calendar day, 12 months later.
2. The 12-month period must be made up of consecutive months. Any 12 month period can be used if the 330 days in a foreign country fall within that period. It is very important that you count only full 24-hour days.
3. The 12-month period does not have to begin with the first full day the taxpayer left. Instead, taxpayers can choose the 12-month period that gives them the greatest exclusion.
4. In determining whether the 12-month period falls within a longer stay in the foreign country, 12-month periods can overlap one another.

The 12-month period can be any consecutive days.

Consider:

March 15, 2006 – March 14, 2007	= 12 months
July 1, 2006 – June 30, 2007	= 12 months
January 1, 2007 – December 31, 2008	= 12 months

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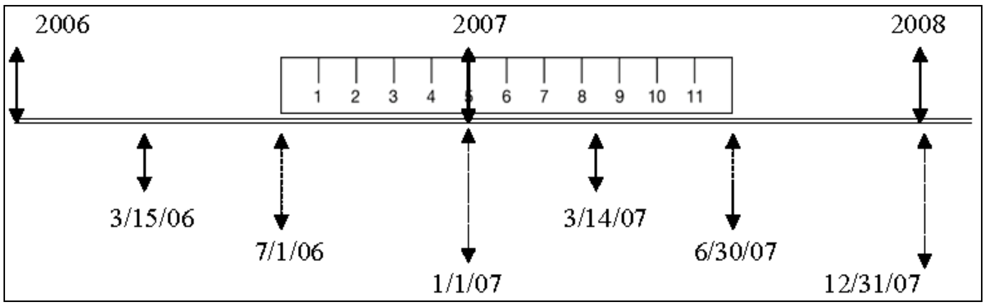
To put this in graphical terms, imagine that a 12-inch ruler represents a 12 month span. Now imagine that the taxpayer's tax years are along a straight timeline. If, by moving this ruler anywhere along the timeline, taxpayer can find two 12-month periods in which he meets the 330-day test that cover all of the days of his tax year, he may claim the full exclusion for that year.



Shifting the 12 Month Period

Key Points:

- The concept to get across here is that a taxpayer can have two overlapping qualifying periods that cover all or part of a taxable year. Don't get bogged down on this issue; most returns do not contain shifting 12 month periods.
- Although called "shifting," this term really means that a taxpayer may have as many different 12-month periods (12-month periods which begin/end on different days) as it takes to ensure that he receives the maximum exclusion allowable for any particular tax year.
- Once the taxpayer meets the 330-days requirement under the physical presence test, the 12-month period can be shifted in such a way that each partial year will have a greater number of qualifying days. Since the number of qualifying days in the tax year determines the maximum exclusion allowable, the taxpayer may wish to shift his period in order to increase his exclusion.
- There are 365 days in the year (366 in leap years) but only 330 days must be spent on foreign soil to meet the physical presence test. This means that 35 (or 36) days may be spent in the U.S. without breaking the qualifying period. These days may be at the beginning, the end, or in the middle of the 12-consecutive-month period. A taxpayer may have qualifying days even before he enters a foreign country.

Continued on next page

Example 4

Lisa arrives in Paris on July 14, 2007. Her first full day of presence is July 15, 2007. She remained in Paris for 330 days, departing on June 11, 2008.

Her 12-month period beginning in 2007 can be June 20, 2007 to June 19, 2008, giving her the exclusion for the days between June 20 and December 31, 2007.

Her 12-month period ending in 2008 can be July 17, 2007 to July 16, 2008, giving her 2008 exclusion for all of the days from January 1 to July 16, 2008.

Example 5

John is a construction worker who works on and off in Canada over a 20-month period. The first few and last few months of the 20-month period were broken up by long visits to the U.S. John might pick up the 330 full days in a 12-month period only during the middle months of the time he worked in Canada because of the visits to the U.S.

1. Can any 12-month period be used if a taxpayer travels to and from the U.S. within a 12-month period?

   Answer: Yes, as long as they are made up of consecutive days.

2. Explain why a 12-month period does not have to begin with the first full day in the foreign country.

   Answer: Because the taxpayer can choose any 12-month period with at least 330 qualifying foreign days.

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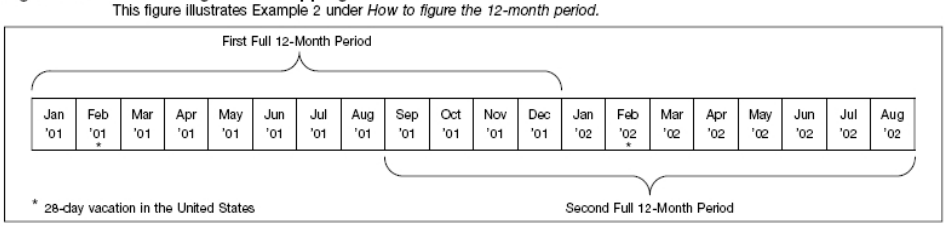
Exercise 9

Margie worked in Portugal for a 20-month period from January 1, 2007 through August 31, 2008, except that she spent 28 days in February 2007 and 28 days in February 2008 on vacation in the U.S. Can Margie meet the physical presence test for the entire 20-month period?

Answer: Yes. Margie was present in Portugal 330 full days during each of the following 12-month periods: January 1, 2007–December 31, 2007, and September 1, 2007–August 31, 2008. By overlapping the 12-month periods in this way, she meets the physical presence test for the whole 20-month period.

Figure 4–B. **How To Figure Overlapping 12-Month Periods**
This figure illustrates Example 2 under *How to figure the 12-month period.*



Since you can never shift the qualifying period under the bona fide residence test, the qualifying period starts with the first full foreign day.

A taxpayer may choose to use the physical presence test in his first and last years overseas, and the bona fide residence test in between.

Remember, for the purpose of shifting periods, the period can be shifted backwards, forwards, and towards the middle. A 12-month consecutive period contains 365/366 days. If you take 365 days less the 330 days requirement, and the days in the U.S. during that period, the 35-day difference is the maximum number of days that can be shifted.

To shift forward to increase the number of days at the end of a period, you would take the last full day on foreign soil and count back 330 days. If any of this time was in the U.S., you would add these U.S. days to 330 and then count backwards. One year forward from that date will be the end of the qualifying period.

Break in the Qualifying Period

There is one other situation involving shifting. If a taxpayer's qualifying period is broken (for example, the taxpayer is on U.S. soil for more than the allowed 35 days), the taxpayer can bring two 12-month periods together (shift both periods toward the middle – shift forward in the first period, backwards in the second).

Example 6

Dan arrives in France on June 1, 2006. His first full day of presence is June 2, 2006. He returns to the U.S. permanently on August 1, 2008. For whatever reason, Dan was in the U.S. from June 1 through July 31 of 2007, thus being in a foreign country only 304 days in 2007.

What would Dan's maximum exclusion for 2007 be?

If Dan only looks at the calendar year 2007, he would not be entitled to any exclusion, because the 12-month period from January 1, 2007 to December 31, 2007 does not include 330 days of physical presence. If, instead, Dan were to use two different 12 month periods, he would not only qualify for the exclusion under physical presence, he would also be entitled to the full $85,700.

Period #1 would be from July 1, 2006 to June 30, 2007. During this 12-month period, he is physically present in France for 335 days (the period from July 1, 2006 until June 30, 2007). Thus, for 2007, Dan is entitled to the exclusion for all of the days in the qualifying period that fall within the tax year, i.e., the period from January 1, 2007 until June 30, 2007, or 181 days.

Dan now selects for Period #2 the 12 months from July 1, 2007 through June 30, 2008. During this period, he is physically present in France for 335 days, thus meeting the physical presence test for this period. Note that 2008 is a leap year. Again, this entitles Dan to the 2007 foreign exclusion for all of the days in this 12-month period which falls in the calendar year 2007, which is 184 (the days from July 1,2007 though December 31, 2007). He thereby is entitled to the entire year's exclusion of $85,700 by carefully selecting the various 12-month periods during which he meets the physical presence test.

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Break in the Qualifying Period, Continued

Remember that the taxpayer may choose any combination of 12 month periods so long as the 330 day requirement is met within each. These periods may even overlap each other. Just remember, this shifting is to only determine if particular days qualify for the exclusion; taxpayer doesn’t get to claim the exclusion twice just because a particular day falls into two different 12 month periods.

Also note that the taxpayer may not be able to find a combination of periods to shift that covers all the days in the tax year. In that case, he may still count the number of days that do fall into qualifying periods to determine his allowable exclusion.

Exceptions to the Tests

There are two exceptions to meeting the requirements under the bona fide residence and physical presence tests.

Both the bona fide residence test and the physical presence test contain minimum time requirements. The minimum time requirements can be waived, though, if the taxpayer must leave the country because of war, civil unrest, or similar adverse conditions in that country. The taxpayer also must be able to show that they reasonably could have expected to meet the minimum time requirements if not for the adverse conditions. To qualify for the waiver, the taxpayer must actually have their tax home in the foreign country and be a bona fide resident of, or be physically present in, the foreign country on or before the beginning date of the waiver.

Early each year, the Service publishes in the IRB a list of countries qualifying for the waiver and the effective dates. If the taxpayer left one of the countries on or after the date listed, they can qualify for the bona fide residence test or the physical presence test without meeting the minimum time requirements. However, in figuring the exclusion, the number of qualifying days of bona fide residence or physical presence includes only those days of actual residence or presence within the country.

If the taxpayer is present in a foreign country in violation of U.S. law, they will not be treated as a bona fide resident of a foreign country or as physically present in a foreign country while they are in violation of the law. Income that is earned from sources within such a country for services performed during a period of violation does not qualify as foreign earned income. Any housing expenses incurred by the taxpayer within that country (or outside that country for housing the taxpayer's spouse or dependents) while the taxpayer is in violation of the law cannot be included in figuring your foreign housing amount.

For 2008, the only country to which travel restrictions apply is Cuba. The restrictions previously placed on travel to Iraq and Libya ended in 2004.

* Cuba	– January 1, 1987	– Continues
* Iraq	– August 2, 1990	– Ended July 29, 2004
* Libya	– January 1, 1987	– Ended September 20, 2004

Foreign Earned Income

Reading Assignment

Read Treas. Reg. §§ 1.911-3(a), (b), and (c).

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the taxpayer must have income earned in a foreign country.

Foreign earned income generally is income you receive for services performed during a period which the taxpayer: (a) maintains a tax home in a foreign country; and (b) meets either the bona fide residence test or the physical presence test.

Foreign earned income does not include the following amounts:

1. The value of meals and lodging that were excluded from income because it was furnished for the convenience of the employer.
2. Pension or annuity payments received, including Social Security benefits.
3. Pay received as an employee of the U.S. government.
4. Amounts included in income because of the employer's contributions to a nonexempt employee trust or to a nonqualified annuity contract.
5. Any unallowable moving expense deduction that is recaptured.
6. Payments received after the close of the first taxable year following the taxable year in which the services giving rise to the amounts were performed.

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Earned Income Earned income is pay for personal services performed, such as wages, salaries, or professional fees.

Earned Income	Unearned Income	Variable Income
Salaries and wages	Dividends	Business profits
Commissions	Interest	Royalties
Bonuses	Capital gains	Rents
Professional fees	Gambling winnings	
Tips	Alimony	
	Social Security benefits	
	Pensions	
	Annuities	

In addition to the types of earned income listed, certain non-cash income and allowances or reimbursements are considered earned income. For example, the fair market value of property or facilities provided by an employer in the form of lodging, meals, or use of a car is earned income.

Emphasize that there are certain non-cash income and allowances or reimbursements that can be identified as earned income.

- Cost-of-living allowances
- Overseas differential
- Family allowance
- Reimbursement for education or education allowance
- Home leave allowance
- Quarters allowance
- Reimbursement for moving or moving allowance (unless excluded from income).

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Source of Earned Income

The source of earned income is the place where the services were performed for which the income was received. Refer to Chapter 2. Foreign earned income is income received for working in a foreign country. Where or how the taxpayer is paid has no effect on the source of income. For example, income received for work done in Austria is income from a foreign source even if the income is direct deposited to a bank in the U.S., and the employer is located in the U.S.

If income is received for specific work done in the U.S., the income must be reported as U.S. source income. If it cannot be determined how much income is for work done in the U.S., or for work done partly in the U.S. and partly in a foreign country, determine the amount of U.S. source income using the method that most correctly shows the proper source of income.

Key Points:

- Discuss how this section will work with the foreign tax credit provisions that the students will work with later. Sourcing is a key ingredient in computing the correct tax. Allocation of fringe benefits is an area where adjustments are common. The new sourcing rules that went into effect for 2006 and subsequent tax years are not well understood by taxpayers or accountants.
- In most cases, for tax years beginning prior to July 14, 2005, you can make this determination on a time basis. U.S. source income is the amount that results from multiplying total pay (including allowances, reimbursements other than for foreign moves, and non-cash fringe benefits) by a fraction. The numerator is the number of days worked within the U.S. The denominator is the total number of days of work paid.

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Source of Earned Income (continued)

Example 7

Larry is a U.S. citizen, a bona fide resident of Germany, and working as a mining engineer. His salary is $76,800 per year. Larry also receives a $6,000 cost-of-living allowance, and a $6,000 education allowance. His employment contract did not indicate that he was entitled to these allowances only while outside the U.S. Larry's total income is $88,800 ($76,800 + $6,000 + $6,000). Larry works a 5-day week, Monday through Friday. After subtracting a vacation that he took, Larry had a total of 240 paid workdays in the year. He worked in the U.S. during the year for 6 weeks (30 workdays). To determine U.S. source earned income, divide the number of days worked in the U.S. during the year (30) by the total number of days of work paid (240). Multiply the result (30/240 = 0.125) by the total income ($88,800). The result, $11,100, is the U.S. source earned income.

Sourcing – New Rules

For tax years beginning after July 14, 2005 (essentially for 2006 and forward), there are some exceptions to the "sourcing where services are provided" rule. These are outlined in the current Treas. Reg. § 1.861-4. These exceptions are Geographic Sourcing and Alternative Basis Sourcing.

Geographic Sourcing – Sourcing certain fringe benefits which are outlined in the Regulation based on locations other than where the services were performed:

- Payments to employees for Housing, Education, and Local Transportation are sourced based on the location of the individual's principal place of work.
- Tax Reimbursements – Sourcing is based on the location of the jurisdiction that imposed the tax for which the individual is reimbursed.

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Sourcing – New Rules (continued)

- Hazard/Hardship pay – Sourcing is determined based on the location of the hazardous/hardship duty zone for which the pay is paid. A hazardous/ hardship duty zone is any place in a foreign country which is either designated by the Secretary of State as a place where living conditions are extraordinarily difficult, notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under 5 U.S.C. § 5925(b) to any officer or employee of the U.S. government present at that place, or where a civil insurrection, civil war, terrorism, or wartime conditions threatens physical harm or imminent danger to the health and well-being of the individual. Compensation provided an employee during the period that the employee performs labor or personal services in a hazardous or hardship duty zone may be treated as a hazardous or hardship duty pay fringe benefit only if the employer provides the hazardous or hardship duty pay fringe benefit only to employees performing labor or personal services in a hazardous or hardship duty zone. The amount of compensation treated as a hazardous or hardship duty pay fringe benefit may not exceed the maximum amount that the U.S. government would allow its officers or employees present at that location.
- Moving Expense – Sourcing is based on the location of the employee's new principal place of work. The source of such compensation is determined based on the location of the employee's former principal place of work unless the individual provides sufficient evidence that such determination of source is more appropriate under the facts and circumstances of the particular case. Sufficient evidence generally requires a written agreement or a statement of company policy, which is reduced to writing before the move and which is entered into or established to induce the employee or employees to move to another country. Such written statement or agreement must state that the employer will reimburse the employee for moving expenses that the employee incurs to return to the employee's former principal place of work regardless of whether he or she continues to work for the employer after returning to that location.

Continued on next page

Sourcing – New Rules (continued)

Alternative Basis Sourcing – An individual may determine the source of his or her compensation as an employee for labor or personal services performed partly within and partly without the U.S. under an alternative basis if the individual establishes to the satisfaction of the Commissioner that, under the facts and circumstances of the particular case, the alternative basis more properly determines the source of the compensation. In addition, the individual must provide the information related to the alternative basis required by applicable Federal tax forms and accompanying instructions.

Earned and Unearned Income

Earned income is pay for personal services performed. Some types of income are not easily identified as earned or unearned income, such as income from sole proprietorships, partnerships, corporations, stock options, pensions, annuities, royalties, rents, and fringe benefits. Income from sole proprietorships is generally treated differently than income from corporations.

Trade or Business – Sole Proprietorship or Partnership

Income from a business in which capital investment is an important part of producing the income may be unearned income. If the taxpayer is a sole proprietor or partner, and personal services are an important part of producing the income, the part of the income that represents the value of personal services will be treated as earned income.

If capital investment is an important part of producing income, no more than 30% of the share of net profits of the business is earned income. If there are no net profits, the part of gross profit that represents a reasonable allowance for personal services actually performed is considered earned income.

If capital is not an income-producing factor and personal services produce the business income, the 30% rule does not apply. The entire amount of business income is earned income. Treas. Reg. § 1.911-3(a), (b) (2).

Key Points:

- Spend a little time with this item. What kinds of Schedule Cs would have capital as an income producing factor? How does that affect the amount of the IRC § 911 exclusion?
- Remember that where there is a Schedule C, the IRC § 911 exclusion is based on Gross Profit and not Net Schedule C income. Many taxpayers use the net profit instead of the gross which can give them a larger exclusion than they are entitled to claim.

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Trade or Business – Sole Proprietorship or Partnership (continued)

Example 8

Vincent is a U.S. citizen and meets the bona fide residence test. He invested in a partnership based in Australia that is engaged solely in selling merchandise outside the U.S. Vincent performed no personal services for the partnership. At the end of the tax year, his share of net profits is $80,000. The entire $80,000 is unearned income.

Example 9

Assume Vincent spent time operating the business. His share of the net profits is $80,000, and 30% of the share of the profits is $24,000. If the value of his services for the year is $15,000, his earned income is limited to the value of his services, $15,000.

Example 10

Howard and Alex are management consultants and operate as equal partners in performing services outside the U.S. Because capital is not an income-producing factor, all the income from the partnership is considered earned income.

The salary received from a corporation is earned income only if it represents a reasonable allowance as compensation for work done for the corporation. Any amount over what is considered a reasonable salary is unearned income.

Example 11

Dan was a U.S. citizen and an officer and stockholder of Dan, Inc. in Tierra del Fuego. Dan performed no work or service of any kind for Dan, Inc. During the tax year, Dan received a $10,000 “salary” from Dan, Inc. The $10,000 is not for personal services, and therefore is unearned income.

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Stock Options

A taxpayer may have earned income if they disposed of stock that they received by exercising stock options granted to them under an employee stock purchase plan.

If the gain on the disposition of stock received by exercising an option is treated as capital gain, then gain is considered unearned income.

However, if the stock is disposed of less than two years after the taxpayer was granted the option, or less than 1 year after the taxpayer got the stock, part of the gain on the disposition may be earned income. It is considered received in the year the stock is disposed and earned in the year the service was performed for which the taxpayer was granted the option. Any part of the earned income that is due to work done outside the U.S. is foreign earned income. In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option).
See Treas. Reg. § 1.861-4(b)(2)(ii)(F).

Pensions and Annuities

For purposes of the foreign earned income exclusion, the foreign housing exclusion, and the foreign housing deduction, amounts received as pensions or annuities are unearned income.

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Royalties

Royalties from the leasing of oil and mineral lands and patents generally are a form of rent or dividends and are unearned income. Royalties received by a writer are earned income if they are received:

1. For the transfer of property rights of the writer in the writer's product, or
2. Under a contract to write a book or series of articles.

Use of Employer's Property or Facilities

If the taxpayer receives fringe benefits in the form of the right to use an employer's property or facilities, the fair market value of that right must be added to the taxpayer's pay.

Reimbursement of Moving Expense as Income

While moving expenses are deductible, reimbursement of moving expenses constitutes income. Taxpayers must report the full amount of the reimbursement income in the year received or accrued.

Reimbursement of foreign moving expenses may qualify for exclusion. Although the reimbursement is income in the year it is received, the amount subject to exclusion sometimes must be spread over two years.

Instructor Notes

Instructor should stress the statement above that the moving expense reimbursement <u>must</u> be reported in full in the tax year the reimbursement was received.

Reading Assignment

Read Treas. Reg. §§ 1.911-3(e)(5) and 1.911-3(f).

Foreign earned income under the foreign earned income exclusion may include reimbursement of moving expenses. A taxpayer must include as earned income:

1. Any reimbursements of, or payments for, nondeductible moving expenses;
2. Reimbursements that are more than the deductible expenses and that are not returned to the employer;
3. Any reimbursements made (or treated as made) under a non-accountable plan even if they are for deductible expenses; and
4. Any reimbursement of moving expenses deducted in an earlier year.

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In general, when determining whether moving expense reimbursements are attributable to services performed in a foreign country or in the U.S., the reimbursements are considered to be payment for future services at the new place of work. For example, when an employer reimburses an employee for a move to the U.S. from Italy, the payment is considered to be for future services performed in the U.S. Accordingly, the payment would not be eligible for the foreign income exclusion and would simply be reported as income on the employee's Form 1040. On the other hand, if the employee is reimbursed for a move from the U.S. to Italy some or all of the reimbursement may be excluded from income because it is attributable to future services to be performed in Italy. (Agreements between employers and employees may change this result.)

Move from U.S. to a Foreign Country

While a taxpayer must report reimbursement of moving expenses as income in the year of receipt, a taxpayer may also claim an earned foreign income exclusion for all or a portion of the reimbursement. However, there is a timing element to the claim for exclusion.

If a taxpayer moves from the United States to a foreign country, the moving expense reimbursement is considered earned foreign income for future services to be performed at the new location.

If the taxpayer qualifies under the bona fide residence test or the physical presence test for at least 120 days during the year of the move, the reimbursement is considered earned foreign income in that year.

If the taxpayer does not qualify, only a portion of the reimbursement is considered earned in the move and the balance is considered earned in the following year. To figure the amount earned in the year of the move, multiply the reimbursement by a fraction. The numerator of the fraction is the number of days in the qualifying period that fall within the year of the move, and the denominator is the total number of days in the year of the move.

The difference between the total reimbursement and the amount considered earned in the year of the move is the amount considered earned in the year following the year of the move.

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Move from U.S. to a Foreign Country (continued)

Example 2

Bob is a U.S. citizen working in the United States. Bob was transferred to Brazil. Bob arrived in Brazil on December 20, 2007, and Bob did not qualify as a bona fide resident for the remainder of 2007. Bob's employer reimbursed him $2,000 in January 2008, for the part of the moving expense that Bob was not allowed to deduct.

Because Bob did not qualify as a bona fide resident for at least 120 days in the year of the move, the reimbursement is considered pay for services performed in Brazil for both 2007 <u>and</u> 2008.

Bob must file an *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return* (Form 4868) with the Internal Revenue Service for his 2007 tax year so he can establish himself as a bona fide resident and claim foreign earned income exclusion.

For 2007, Bob multiplies the amount of the reimbursement by a fraction. The fraction is the number of days he was a bona fide resident in Brazil divided by 365:

$2,000 × (11/365) = $60

Bob must report as income the $2,000 received in 2008. He can claim foreign earned income exclusion for $60 in 2007. He can claim foreign earned income exclusion for $1, 940 in 2008.

Instructor Notes

Bob does NOT report the $88.00 in 2007. He reports the whole $2,000.00 in 2008.

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Move between Foreign Countries

If the taxpayer moves between foreign countries, any moving expense reimbursement that must be included in income will be considered as earned in the year of the move if the taxpayer qualifies under either the bona fide residence test or the physical presence test for a period that includes at least 120 days in the year of the move.

Reference: Rev. Rul. 76-162

Move to U.S.

If the taxpayer is moving to the United States, the moving expense reimbursement that must be included in income is generally considered to be U.S. source income.

However, if under either an agreement between the taxpayer and their employer or a statement of company policy that is reduced to writing before the move to the foreign country, the employer will reimburse the taxpayer for their move back to the United States regardless of whether they continue to work for the employer, the includible reimbursement is considered compensation for past services performed in the foreign country. The includible reimbursement is considered earned in the year of the move if the taxpayer qualifies under the bona fide residence test or the physical presence test for at least 120 days during that year. Otherwise, the taxpayer treats the includible reimbursement as received for services performed in the foreign country in the year of the move and the year immediately before the year of the move.

The calculation of the includible reimbursement considered earned in the year of the move is the same as was discussed earlier under "Move from U.S. to Foreign Country."

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Move to U.S. (continued)

Example 3

Roger is a U.S. citizen employed in Romania. Roger resigned from employment with his employer on March 31, 2006, and returned to the United States after having been a bona fide resident of Romania for several years. A written agreement with Roger's employer entered into before Roger went abroad provided that he would be reimbursed for his move back to the United States.

In April 2006, Roger's former employer reimbursed Roger $2,000 for the part of the cost of his move back to the United States that he was not allowed to deduct. Because Roger was not a bona fide resident of Romania for at least 120 days in 2006 (the year of the move), the includible reimbursement is considered pay for services performed in Romania for both 2006 and 2005. Roger must divide his claim for foreign earned income exclusion between 2006 and 2005.

Roger figures the part of the moving expense reimbursement for services performed in Romania for 2006 by multiplying the total reimbursement ($2,000) by a fraction. The fraction is the number of days of foreign residence during the year (90) divided by the number of days in the year (365).

$\$2{,}000 \times (90/365) = \$493$

The $493 is considered income earned in Romania in 2006; the remainder of $1,507 is considered income earned in Romania in 2005.

Instructor Notes

Reinforce the importance of ensuring that the move must occur within 1 year of ending active duty.

U.S. Government Employees

For purposes of the foreign earned income exclusion, the foreign housing exclusion, and the foreign housing deduction, foreign earned income does not include any amounts paid by the U.S. or any of its agencies to its employees. Payments to employees of non-appropriated fund activities are not foreign earned income. Non-appropriated fund activities include the following employers:

1. Armed forces post exchanges
2. Officers' and enlisted personnel clubs
3. Post and station theaters
4. Embassy commissaries

Amounts paid by the U.S. or its agencies to persons who are not their employees may qualify for exclusion or deduction.

Key Points:

- U.S. government employees do not always get W-2 forms. Sometimes employees of the U.S. military overseas are locally hired and do not get W-2's at all. Other times they work under Personal Service Contracts and attempt to claim that they are self-employed. Discuss the differences between self-employed individuals and employees and the common law elements that are used to make the determinations.
- If the taxpayer is a U.S. government employee paid by a U.S. agency that assigned them to a foreign government to perform specific services for which the agency is reimbursed by the foreign government, the taxpayer's pay is from the U.S. government and does not qualify for exclusion or deduction.
- Those military assigned to NATO are not entitled to exclude any portion of their income. See handout on NATO. The Internal Revenue Service, on July 23, 1999, issued a determination letter to the Department of Defense; also see Chief Counsel Advisory 199937041, issued September 17, 1999. IRC § 911 does not apply to military earnings of U.S. uniformed personnel.

Summary

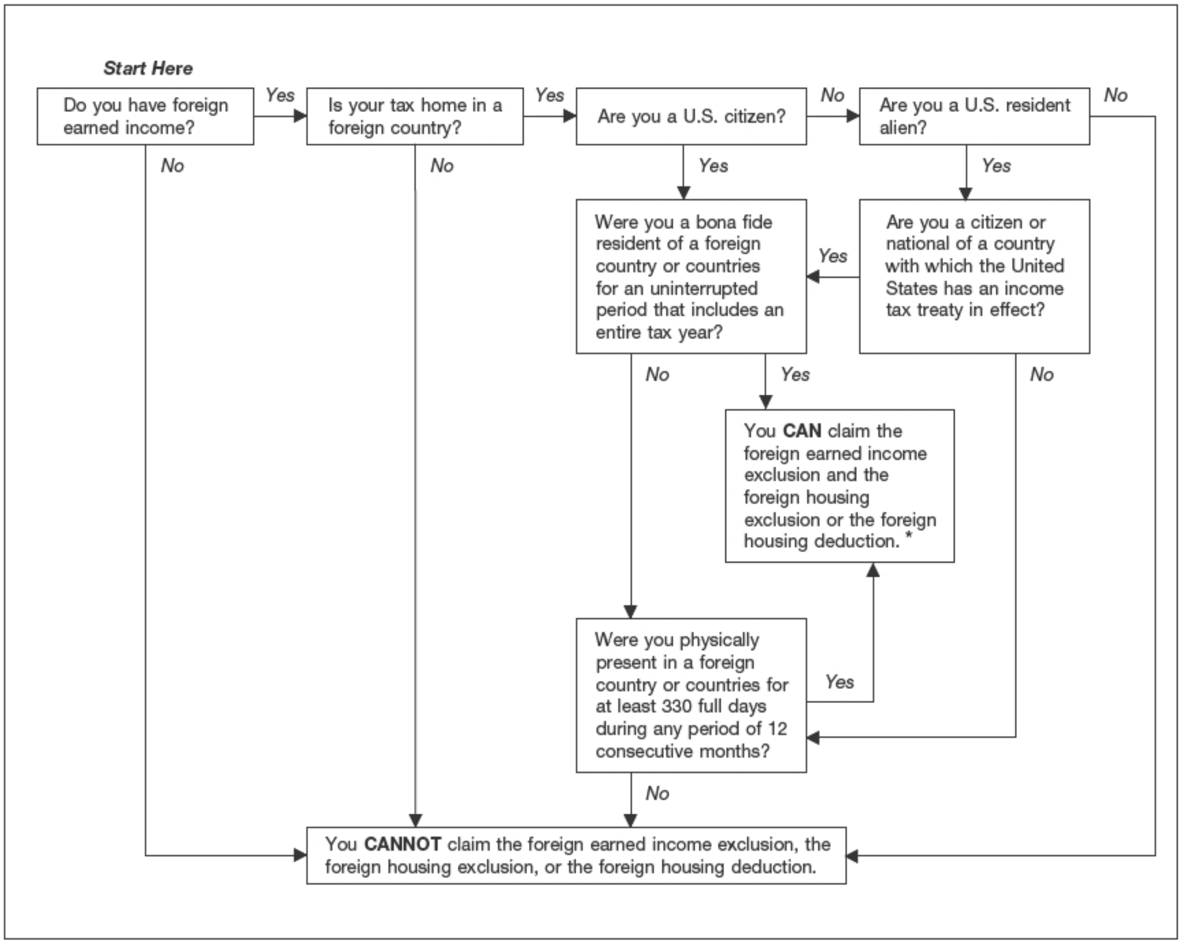
1. Taxpayers having income earned abroad can qualify for special tax benefits once they have established bona fide residence in a foreign country, or are physically present on foreign soil for 330 full days in any 12-consecutive-month period, have a foreign tax home and do not have an abode in the U.S.
2. Bona fide residence can be established by a taxpayer's intent, length of stay, payment of taxes to foreign governments, etc. For calendar year taxpayers, the qualifying period includes the entire tax year, from January 1 to December 31.
3. Physical presence only involves being physically present on foreign soil for 330 days, 24 hours a day in any 12-consecutive-month period.
4. Once a taxpayer qualifies for either the bona fide residence test or the physical presence test, they can claim the benefits of the 911 exclusion from the beginning of the qualifying period.
5. Income must be earned in a foreign country. In the case of wages, this would be where the services were performed.
6. Sole proprietors, partners, and corporate officers and employees may be limited on the amount allowable as a basis for deduction or exclusions.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

Appendix 7-A, *Flowchart Illustrating Requirements*

Figure 4–A. **Can I Claim Either Exclusion or the Deduction?**



* Foreign housing exclusion applies only to employees. Foreign housing deduction applies only to the self-employed.

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International Technical Training

Chapter 7

Foreign Earned Income Exclusion

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 4 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • 2010 Form 2555 Form and Instructions
Participant References	• CCH and Form 2555
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides • Flipcharts and markers

Overview

Introduction

This lesson will deal with the actual calculation of the foreign earned income exclusion, the foreign housing exclusion, and the foreign housing deduction. It will build on the concepts introduced in Lesson 6.

Instructor Notes

Display and state the *Objective*s. May use flipcharts, transparency, and PowerPoint slides.

Objectives

At the end of this lesson, the student will be able to:

- Determine the basic foreign earned income exclusion.
- Determine the housing cost amount exclusion.
- Determine the housing cost amount deduction.
- Determine the correct tax calculation for someone who has claimed the foreign earned income exclusion.

Reading Assignment

Read IRC § 911(a).

Review

A person must be either a bona fide resident or be physically present in a foreign country, and have his/her tax home outside of the U.S. and have foreign earned income in order to qualify for IRC § 911 exclusion.

Continued on next page

Contents

This lesson covers the following topics:

Basic Exclusion

If a taxpayer's tax home is in a foreign country and they meet the bona fide residence test or the physical presence test, they can choose to exclude from their income a limited amount of their foreign earned income.

A taxpayer can also choose to exclude from their income a foreign housing amount. If a taxpayer chooses to exclude a foreign housing amount, they must figure the foreign housing exclusion before they figure the foreign earned income exclusion. The foreign earned income exclusion is limited to foreign earned income minus any foreign housing exclusion.

If a taxpayer chooses to exclude foreign earned income or housing expenses, they cannot deduct, exclude, or claim a credit for any item that can be allocated to or charged against the excluded amounts. This includes any expenses, losses, and other normally deductible items allocable to the excluded income.

Limit on Excludable Amount

The taxpayer may be able to exclude up to $91,500 of income earned in 2010. The table below shows the maximum amount excludable for all years:

Year	Maximum Excludable Amount
2006	$82,400
2007	$85,700
2008	$87,600
2009	$91,400
2010	$91,500
2011 and later	Indexed for Inflation

For any tax year, the taxpayer cannot exclude more than the smaller of:

1. the Maximum Excludable Amount for that tax year in the chart above, or
2. the foreign earned income for the tax year minus the foreign housing exclusion.

If both the taxpayer and spouse work abroad and both spouses meet either the bona fide residence test or the physical presence test, they can each choose the foreign earned income exclusion. Both do not need to meet the same test. Together, they can exclude as much as $183,000 for 2010.

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Payment in Year Following Work

Generally, a taxpayer is considered to have earned income in the year in which the work is done for which they receive the income, even if the taxpayer is not paid for that work until the following year. If a taxpayer reports on a cash basis, they report income on their return for the year they receive it. If the taxpayer does work in one year, but is not paid for that work until the next year, the amount they can exclude in the year they are paid is the amount they could have excluded in the year they did the work if they had been paid in that year.

Example 1

Beatrice qualifies as a bona fide resident of Brazil for all of 2007 and 2008. She reports her income on the cash basis. In 2007, she was paid $71,000 for work she did in Brazil during that year. She excluded all of the $71,000 from her income in 2007. In 2008, Beatrice was paid $103,000 for her work in Brazil; $12,000 was for work she did in 2007, and $91,000 was for work she did in 2008. What is the maximum foreign earned income exclusion Beatrice can claim for 2008?

She can exclude all of the $12,000 of her 2007 income in 2008. The maximum exclusion in 2007 was $85,700. Subtract from that the $71,000 Beatrice actually excluded in 2007. Beatrice can exclude $87,600 of the $91,000 she was paid for work she did in 2008 from her 2008 income. Beatrice's total foreign earned income exclusion for 2008 is $99,600 ($12,000 plus $87,600).

Exercise 1

Maria arrives in England on March 23, 2007. Her physical presence period begins March 24, 2007 and ends March 23, 2008. From March 24, 2007 to December 31, 2007, she has 283 days in her physical presence period in tax year 2007. What is Maria's maximum exclusion?

Answer:

Continued on next page

Year-End Payroll Period

There is an exception to the general rule that income is considered earned in the year the work is done for which the income was received. For a cash basis taxpayer, any salary or wage payment received after the end of the year in which the work is done for which payment is received is considered earned entirely in the year of receipt if all four of the following rules apply:

1. The period for which the payment is made is a normal payroll period of the employer.
2. The payroll period includes the last day of the tax year (December 31 for most taxpayers).
3. The payroll period is not longer than 16 days.
4. The payday comes at the same time in relation to the payroll period that it would normally come and it comes before the end of the next period.

Income Earned Over More Than 1 Year

Regardless of when income is actually received, it must be applied to the year in which it was earned when figuring the excludable amount for that year. For example, a bonus may be based on work done over several years. The amount of the bonus that is considered earned in a particular year is determined by:

1. Dividing the bonus by the number of calendar months in the period in which the work was done that resulted in the bonus,
2. Multiplying the result of 1, above, by the number of months the work was done during the year. This is the amount that is subject to the exclusion limit for that tax year.

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Income Received More Than 1 Year After It Was Earned

Income received after the end of the year following the year the work was done to earn it may not be excluded.

Example 2

Sally qualified as a bona fide resident of Sweden for 2006, 2007, and 2008. Sally reports her income on the cash basis. In 2005, Sally was paid $65,000 for work she did in Sweden that year and in 2006 Sally was paid $70,000 for that year's work done in Sweden. Sally excluded $65,000 on her 2005 Federal income tax return and $70,000 on her 2006 return. In 2007, Sally was paid $90,000, $80,000 for work she did in Sweden in 2007, and $10,000 for work she did in Sweden in 2005. Can Sally exclude any of the $10,000?

Sally cannot exclude any of the $10,000 for work done in 2005 because she received it after the end of the year following the year in which she earned it. That is, she received it after 2006. She must include the $10,000 in income. She can exclude all of the $80,000 received for work she did in 2007.

Part-Year Exclusion

If the taxpayer qualifies under either the bona fide residence test or the physical presence test for only part of the year, they must adjust the maximum limit based on the number of qualifying days in the year. The number of qualifying days is the number of days in the year within the period in which the taxpayer both:

1. has a tax home in a foreign country, and
2. meets either the bona fide residence test or the physical presence test.

For this purpose, count as qualifying days all days within a period of 12 consecutive months once physically present and has a tax home in a foreign country for 330 full days. To figure the maximum exclusion, multiply the maximum excludable amount for the year by the number of qualifying days in the year, and then divide the result by the number of days in the year.

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Part-Year Exclusion (continued)

Example 3

Janice reports her income on the calendar-year basis and qualifies under the bona fide residence test for 75 days in 2007. She can exclude a maximum of 75/365 of $85,700, or $17,610, of her foreign earned income for 2007. If she qualifies under the bona fide residence test for all of 2007, she can exclude her foreign earned income up to the full $85,700 limit.

Under the physical presence test, a 12-month period can be any period of 12 consecutive months that includes 330 full days. Assuming they qualify under the physical presence test for part of a year, it is important for the taxpayers to carefully choose the 12-month period that will allow them the maximum exclusion for that year.

Example 4

Frank was physically present and had a tax home in France for a 16-month period from June 1, 2007 through September 29, 2008, except for 15 days in December 2007 when he was on vacation in the United States.

Frank figures his maximum exclusion for 2007 as follows:

1. Beginning with June 1, 2007, he counts forward 330 full qualifying days. He does not count the 15 days he spent in the United States because they do not qualify, so he counts a total of 345 days forward. The 330th qualifying day (which is the 345th total day), May 11, 2008, is the last day of a 12-month period.
2. Frank then counts backward 12 months from May 11, 2008 to find the first day of this 12-month period. This 12-month period runs from May 12, 2007 through May 11, 2008.
3. Frank counts the total calendar days during 2001 that fall within this 12-month period. That is 234 days (May 12, 2007 – December 31, 2007).
4. Frank multiplies $85,700 by the fraction 293/366 to find his maximum exclusion for 2007 of $54,942.

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Part-Year Exclusion (continued)

Example 4 (continued)

Frank finds the maximum exclusion for 2008 in the opposite manner:

1. Beginning with the last full day, September 29, 2008, Frank counts backward 330 full days. He does not count the 15 days he spent in the United States, so he counts backward a total of 345 days. That day, October 20, 2007, is the first day of a 12-month period.
2. Frank counts forward 12 months from October 20, 2007 to find the last day of this 12-month period, October 19, 2008. This 12-month period runs from October 20, 2007 through October 19, 2008.
3. Frank counts the total calendar days during 2008 that fall within this 12-month period. This is 292 days (January 1, 2008 – October 19, 2008).
4. Frank multiplies $87,600, the maximum limit for 2008, by the fraction 292/365 to find his maximum exclusion for 2008 of $70,080.

Choosing the Exclusion

Instructor Notes

Have students read and discuss, including Treas. Reg. § 1.911-7.
Allow 10 minutes.

The foreign earned income exclusion is voluntary. The taxpayer can separately elect the foreign earned income exclusion and the foreign housing exclusion by completing the appropriate areas of Form 2555. This initial election of the exclusions on Form 2555 or Form 2555-EZ generally must be made with a timely filed return, an amended return, or a late filed return filed within 1 year from the original due date of the return (determined without regard to any extensions). *See* Treas. Reg. § 1.911-7.

If a taxpayer does not meet the bona fide resident or physical presence test by the due date of the return, they can file the return without claiming the exclusion and amend it after the time periods have been met. Instead, the taxpayer may request an extension of time to file to the end of the qualifying period on Form 2350.

A taxpayer can elect the exclusion on a return filed after the periods described above, provided they owe no Federal income tax after taking into account the exclusion. If the taxpayer owes Federal income tax after taking into account the exclusion, they can elect the exclusion on a return filed after the periods described above, provided they file before the IRS discovers that they failed to choose the exclusion. The taxpayer must type or legibly print at the top of the first page of the Form 1040 “Filed Pursuant to section 1.911-7(a) (2) (i) (D).” If Federal income tax is owed after taking into account the exclusion and the IRS discovers that the taxpayer failed to elect the exclusion, the taxpayer must request a private letter ruling under Treas. Reg. § 301.9100-3 and Rev. Proc. 2009-1.

Continued on next page

Once the taxpayer elects to exclude their foreign earned income or housing amount, the election remains in effect for that year and all later years unless it is revoked. BUT, unless the taxpayer has made a valid election either in a prior year or in the current year, they may not take the exclusion in the current year. Be mindful of this when dealing with delinquent returns.

An election is not required for the housing deduction for self-employed taxpayers.

Revocation

The taxpayer can revoke their election for any year. This is done by attaching a statement revoking one or more previously made elections to the return or amended return for the first year that the taxpayer does not wish to claim the exclusion(s). The taxpayer must specify which election(s) they are revoking. They must revoke separately an election to exclude foreign earned income and a choice to exclude foreign housing amounts. Once made, the revocation is effective for that year and all subsequent years. If the taxpayer revokes an election and within 5 years (starting with the first year revoked) again wishes to take the same exclusion, they must apply to the Service for approval by requesting a letter ruling.

Foreign Tax Credit

Once the taxpayer takes the exclusion on their foreign earned income or foreign housing costs, they cannot take any foreign tax credit for taxes on the income so excluded. The regulations under Treas. Reg. § 1.911-6(c) provide the methodology for this reduction. See Chapters 13 and 14, *Foreign Tax Credit*, for further explanation.

If the taxpayer claims the foreign tax credit and exclusions for foreign earned income and/or housing costs, and does not reduce the foreign tax credit to account for the excluded income, the elections under IRC § 911 may be considered revoked depending upon the amount of foreign tax credit claimed (Rev. Rul. 90-77).

Foreign Housing Exclusion and Deduction

Reading Assignment

Read IRC §§ 911(c) (1) and (2).

In addition to the foreign earned income exclusion, the taxpayer can also claim an exclusion or a deduction from gross income for their housing amounts if their tax home is in a foreign country and they qualify under either the bona fide residence test or the physical presence test.

The housing exclusion applies only to amounts considered paid for with employer-provided amounts. The housing deduction applies only to amounts paid for with self-employment earnings.

Housing Amount

The housing amount is the total of housing expenses for the year minus a base amount.

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Base Amount

The base amount is 16% of the annual salary of a GS-14, step 1, U.S. government employee, figured on a daily basis, times the number of days during the year that the taxpayer meets the bona fide residence test or the physical presence test. The annual salary is determined on January 1 of the year in which the tax year begins.

Note: This is not the same thing as the annual salary in effect for the tax year. For example, on January 1, 2004, the 2003 annual salary table was still in effect. **For tax years beginning with 2006, the base amount is 16% of the maximum foreign earned income exclusion amount (computed on a daily basis) multiplied by the number of days in the qualifying period that fall within the tax year**.

Year	Per year	Per day
2004	$11,581	$31.64
2005	$11,894	$32.59
2006	$13,184	$36.12
2007	$13,712	$37.57
2008	$14,016	$38.29

On January 1, 2004, the GS-14 salary was $72,381 per year (using the 2003 pay scale; the 2004 pay scale not having come into effect yet); 16% of this amount comes to $11,581, or $31.64 per day. To figure the base amount, assuming a calendar-year taxpayer, multiply $31.64 by the number of qualifying days during 2004. Subtract the result from the total housing expenses for 2004 to find the housing amount.

Example 5

Jake qualifies under the physical presence test for all of 2004. During the year, he spends $13,100 for his housing. His housing amount is $13,100 minus $11,581, or $1,519.

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Limitation on Housing Expenses

For tax years 2006 and forward, there is a maximum amount of qualified housing expenses. This maximum is generally 30% of the maximum Foreign Earned Income Exclusion (computed on a daily basis) and multiplied by the number of days in taxpayer's qualifying period that falls within the tax year. For foreign locations in certain high-cost housing areas, the maximum qualified housing expenses can be adjusted by the Secretary. These high cost tables are found in IRS notices and in the Instructions for Form 2555. WARNING – The schedule of high-cost limitations published with the Instructions to the 2006 Form 2555 were amended by the schedule published in Notice 2007-25. See example for London below.

Actual Housing Expenses	$105,000
Housing Expense Limitation For London (2008)	$ 82,900
Base Housing Amount	($ 14,016)
Housing Cost Exclusion	$ 68,884

Choosing the Exclusion

Housing Expenses

Housing expenses include reasonable expenses paid or incurred for housing in a foreign country for the taxpayer, spouse and dependents (assuming the spouse and dependents are living with the taxpayer).

Only housing expenses for the part of the year that the tax home is in a foreign country and when either the bona fide residence or physical presence tests are met qualify for inclusion.

Housing expenses include:

- Rent
- Fair rental value of housing provided in kind by the employer
- Repairs
- Utilities (other than telephone charges)
- Real and personal property insurance
- Nondeductible occupancy taxes
- Nonrefundable fees for securing a leasehold
- Rental of furniture and accessories
- Residential parking

Housing expenses do not include:

- Expenses that are lavish or extravagant under the circumstances
- Deductible interest and taxes
- Cost of buying property, including principal payments on a mortgage
- Cost of domestic labor (maids, gardeners, security guards, etc.)
- Pay television subscriptions
- Improvements and other expenses that increase the value or appreciably prolong the life of property
- Purchased furniture or accessories
- Depreciation or amortization of property or improvements

Note that the taxpayer cannot include in housing expenses the value of meals or lodging that are excluded from gross income or that were deducted as moving expenses.

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Second Foreign Household

Ordinarily, if two foreign households were maintained, reasonable foreign housing expenses would include only costs for the household that bears the closer relationship (not necessarily geographic) to the tax home. However, if a second, separate household is maintained outside the United States for the taxpayer, spouse, or dependents because living conditions near the tax home are dangerous, unhealthful, or otherwise adverse, the expenses for the second household can be included in reasonable foreign housing expenses. However, expenses for more than one second foreign household cannot be included at the same time.

If two households are maintained and the value of one is excluded because an employer provides it, the expenses for the second household can still be included in figuring a foreign housing exclusion or deduction.

Adverse living conditions include a state of warfare or civil insurrection in the general area of the tax home and conditions under which it is not feasible to provide family housing (for example, if the taxpayer lives on a construction site or drilling rig).

Instructor Notes

Have students read text up to “Foreign Housing Deduction” in the Student Guide. Allow 15 minutes.

Foreign Housing Exclusion

If the taxpayer does not have self-employment income, all of their earnings are employer-provided amounts and their entire housing amount is considered paid for with those employer-provided amounts. This means that the taxpayer can exclude (up to the limits) their entire housing amount.

Reading Assignment

Read Treas. Reg. § 1.911-4(d).

Continued on next page

Employer-Provided Amounts

These include any amounts paid, or paid or incurred on the taxpayer's behalf by the employer that are taxable foreign earned income (without regard to the foreign earned income exclusion) to the taxpayer for the year. Employer-provided amounts include:

1. Salary;
2. Reimbursement for housing expense;
3. Amounts employer paid to a third party on behalf of the taxpayer;
4. Fair rental value of company-owned housing furnished to the taxpayer unless that value is excluded;
5. Amounts paid to the taxpayer by the employer as part of a tax equalization plan; and
6. Amounts paid to the taxpayer or a third party by the employer for the education of their dependents.

Note that the housing exclusion is the lesser of:

- that part of the housing cost amount attributable to employer-provided amounts; or
- foreign earned income.

If the housing exclusion is chosen, it must be figured before figuring the foreign earned income exclusion. The taxpayer cannot claim less than the full amount of the housing exclusion to which they are entitled.

As with the foreign earned income exclusion, if the foreign housing exclusion is claimed, the foreign tax credit cannot also be claimed for foreign taxes on income excluded. If the taxpayer does do this, then the election to claim the foreign housing exclusion may be considered revoked (Rev. Rul. 90-77).

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Exercise 2

Chuck earns $95,000 in wages. His employer provides his housing, which has a fair rental value of $12,000. What is Chuck's employer-provided amount?

Answer: Employer provided amounts are $95,000 + $12,000 = $107,000.

Instructor Notes

Have students read Treas. Reg. § 1.911-4(e).

Ask the students: How do you find what part of the housing amount can be excluded?

Allow 20 minutes.

Reading Assignment

Read Treas. Reg. § 1.911-4(e).

Continued on next page

Foreign Housing Deduction

The foreign housing deduction can only be claimed by a taxpayer with self employment income.

How to figure the housing deduction depends on whether the taxpayer has only self-employment income or both self-employment income and employer-provided income.

- **Self-Employed – No Employer-Provided Amounts**
  When all income is from self-employment, the taxpayer can deduct the housing amount, subject to limitations, in figuring adjusted gross income.
- **Self-Employed and Employer-Provided Amounts**
  If the taxpayer is both an employee and a self-employed individual during the year, they can deduct part of their housing amount and exclude part of it. Remember that the housing amount is the housing cost less the base amount. To find the part that is excluded, multiply the housing amount by the employer-provided amount and then divide the result by the foreign earned income. The balance of the housing amount can be deducted, subject to limitations.

  Example 6

  Larry's housing amount for the year is $12,000. During the year, his total foreign earned income is $80,000, of which half ($40,000) is from self-employment and half is from his services as an employee. Half of the housing amount ($12,000/2) is considered provided by Larry's employer. Larry can exclude $6,000 as a foreign housing exclusion. Larry can deduct the remaining $6,000 as a housing deduction, subject to limitations.

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Exercise 3

Leona was a bona fide resident for the entire year of 2008. She had self employment income of $64,500 and wages of $21,500. Her housing expenses were $18,184. What is Leona's housing exclusion?

Answer: $64,500 + $21,500 = $86,000

Limitation of the Housing Deduction

The housing deduction cannot be more than the foreign earned income minus the total of:

1. The foreign earned income exclusion, plus
2. The housing exclusion.

Carryover of Disallowed Housing Deduction

The taxpayer can carry over to the next year, and only to the next year, any part of their housing deduction that is not allowed because of the limit, i.e., if the taxpayer cannot deduct it in the next year, then it cannot be carried forward to the subsequent year. The taxpayer deducts the carryover in figuring adjusted gross income. The amount of carryover deductible is limited to the foreign earned income for the year of the carryover minus the total of the foreign earned income exclusion, housing exclusion, and housing deduction for that year.

Special Rules for Married Couple’s Housing Expenses

Instructor Notes

Have students read this section, and then discuss. Allow 20 minutes.

The amounts allowed for housing exclusions or deductions require special treatment for married couples. Taxpayers may file jointly or separately, and claim the housing amounts separately or jointly, depending on the specific circumstances for each tax year. You must take into account their living arrangements, whether they have separate tax homes, and whether one has a tax home where adverse living conditions exist.

Married Couple Living Together

If a married couple lives together, both may be able to claim a foreign housing exclusion or a foreign housing deduction. If a joint return is filed, housing amounts may be determined either separately or jointly. If separate returns are filed, housing amounts must be determined separately. In determining separate housing amounts, housing expenses can be allocated in any proportion, but each spouse must use his or her full base amount (*see* Treas. Reg. § 1.911-5(a) (3) (i)).

If the housing amount is determined jointly, housing expenses can be combined in one base amount, but only one spouse can claim the housing exclusion or deduction. Either spouse can claim the exclusion or deduction; however, if the spouses have different periods of residence or presence and the spouse with the shorter period of residence or presence claims the exclusion or deduction, only the housing expenses for that shorter period can be claimed (Treas. Reg. § 1.911-5(a)(3)(i)). Each spouse claiming a housing exclusion must figure separately the part of the housing amount that is attributable to employer-provided amounts, based on his or her separate foreign earned income (Treas. Reg. § 1.911-5(a)(3)(iii)).

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Special Rules for Married Couple's Housing Expenses,
Continued

Married Couple Living Together (continued)

Example 7

Ziggy and Mabel live together and file a joint return. Ziggy was a resident of and had his tax home in Utopia from August 17, 2006 through December 31, 2007. Mabel was also a resident of and had her tax home in Utopia from September 15, 2006, through December 31, 2007. During 2006, Ziggy received $50,000 of income earned in Utopia, and Mabel received $25,000 of income earned in Utopia. Ziggy paid $10,000 for housing expenses in Utopia in 2006, of which $7,500 was for expenses incurred from September 15 through the end of the year. Mabel paid $3,000 for housing expenses in 2006, all of which were incurred during the period from September 15 through December 31, 2006.

(Taxpayers may have had separate bank accounts and paid certain amounts separately. The reasons for the separate expenses are just to illustrate the regulations, so accept them as given).

If Ziggy and Mabel elect to figure their housing amount jointly, and Ziggy claims the housing exclusion, their housing expenses would be $13,000 ($10,000 plus $3,000), and their base amount, using Ziggy's period of residence (Aug. 17 through Dec. 31, 2006), would be $4,948. (The base year amount, $13,184, multiplied by the number of qualifying days, 137, divided by the number of days in the tax year, 365. Ziggy's housing amount would be $8,052 ($13,000 less $4,948).

If, instead, Mabel claims the housing exclusion, their housing expenses would be limited to $10,500 ($7,500 plus $3,000) and their base amount, using Mabel's period of residence (Sept. 15 through Dec. 31, 2006), would be $3,901 ($13,184 □ 108 days □ 365 days). Mabel's housing amount would be $6,599 ($10,500 – $3,901).

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Special Rules for Married Couple's Housing Expenses,
Continued

Married Couple Living Apart

If a husband and wife have different tax homes that are not within reasonable commuting distance of each other and neither spouse's residence is within reasonable commuting distance of the other spouse's tax home, both may be eligible to claim either the foreign housing exclusion or the foreign housing deduction. If spouses' tax homes, or one spouse's tax home and the other spouse's residence are within reasonable commuting distance of each other, only one spouse can exclude or deduct his or her (but not total of both) housing cost amount. Regardless of whether spouses file joint or separate returns, the amount of the housing exclusion or deduction must be determined separately for each spouse. If both spouses claim the housing exclusion or the housing deduction, neither can claim the expenses for a qualified second foreign household (see below) maintained for the other.

For example, if both Harry and Wilma are qualified individuals and Harry's tax home is in London and Wilma's tax home is in Paris, then both Harry and Wilma may exclude or deduct their housing cost amounts; however, Harry and Wilma must compute these amounts separately regardless of whether they file joint or separate returns.

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Second Foreign Household

Ordinarily, if two foreign households are maintained, reasonable foreign housing expenses include only the costs for the household that bears the closer relationship (not necessarily geographic) to the taxpayer's tax home. However, if a second, separate household is maintained outside of the U.S. for the taxpayer's spouse or dependents because living conditions near the taxpayer's tax home are dangerous, unhealthful, or otherwise adverse, the expenses for the second household are included in the taxpayer's reasonable foreign housing expenses. Expenses for only one second foreign household may be included (IRC § 911(c) (3) (B); Treas. Reg. § 1.911-4(b) (5)). Adverse living conditions include a state of warfare or civil insurrection in the general area of the taxpayer's tax home or conditions under which it is not feasible to provide family housing (e.g., a requirement to live on a construction site or drilling rig).

Example 8

The same facts as in Example 7, except Ziggy's tax home is Paris and Mabel's tax home is Madrid. Both Ziggy and Mabel may exclude or deduct their housing cost amounts; however, Ziggy and Mabel must compute these amounts separately regardless of whether they file joint or separate returns. If, instead of living in Madrid, Mabel lives in an area where there are adverse living conditions and Mabel maintains Ziggy's home in Paris, then Mabel may add those housing expenses to her housing expenses and compute one base housing amount. In that case, Ziggy may not claim a housing cost amount exclusion or deduction (*see* Treas. Reg. § 1.911-5(a) (3) (ii)).

If two households are maintained and the value of one is excluded because it is provided by an employer, the expenses for the second household can be included in determining a foreign housing exclusion or deduction.

Tax Calculation When Claiming the Exclusion

For tax years prior to 2006, taxpayers who claim the FEIE compute the tax on their remaining taxable income as they ordinarily would. Beginning in 2006, however, taxpayers have to pay tax at the rates their taxable income WOULD HAVE BEEN had they not claimed the exclusion. This is done in a two-step calculation wherein Step 1 the claimed exclusion is added back to taxable income and the tax computed. In Step 2 the tax is computed only on the exclusion amount and subtracted from the tax in Step 1.

Example 9

In 2005, Fisher, a single individual, had a taxable income, after claiming an $80,000 exclusion of $120,000. He computes his tax on the $120,000 taxable income. His tax is $28,106.50 with a maximum tax bracket of 28%.

In 2006, Fisher had the same $120,000 taxable income after claiming an exclusion of $80,000. He must first compute the tax on $200,000 ($120,000 taxable income + $80,000 exclusion taken) then subtract from that, the tax computed on the $80,000 exclusion. His tax is $35,852.50 ($52,591.50 [the tax on $200,000] less $16,739 [the tax on $80,000]) with a maximum bracket of 33%.

Worksheets are provided to taxpayers in the instructions to the 1040 for this calculation and one such worksheet can be found in the handouts for Lesson 10.

WARNING – RGS does do this calculation, but ONLY if the exclusions are properly classified in the return setup and ONLY if you make adjustments using the correct issue categorization. 2006 NRP cases do NOT have the issue properly categorized and RGS will not correctly compute the tax unless you correct the categorization to “Form 2555 income exclusion amount.”

Compliance Issues

There are several specific areas of taxpayer non-compliance within IRC § 911 that are currently being emphasized. Those include:

1. Income earned by U.S. government employees – IRC § 911 states that amounts paid by the U.S. government or its agencies is not foreign income, although many government employees claim the foreign earned income exclusion. Amounts excluded from income for government employees is covered in IRC § 912.
2. Sources of income – Income from personal services is earned where the services are provided. Section 911 requires that the income is earned in a foreign country. That is not the same as "foreign earned income," which simply is income earned outside the United States. Merchant seamen and airline employees that are in, on or over international waters are not earning income in a foreign country. Taxpayers must allocate their earnings between: 1) income earned in the United States; 2) income earned in a foreign country; 3) income earned in, on or over international waters; 4) other non-foreign areas. For example, Antarctica is an international area; by treaty, it is not under the control of any country, so it is not considered a foreign country under U.S. law. Earnings in, on, under or over Antarctica are not earned in a foreign country, so do not qualify under IRC § 911.

Summary

1. A taxpayer cannot exclude more than the smaller of:
   a) the maximum allowable foreign earned income exclusion.
   b) the foreign earned income for the tax year minus the foreign housing exclusion.
2. The initial choice of the exclusions on Form 2555 or Form 2555-EZ generally must be made with a timely filed return, an amended return, or a late-filed return filed within 1 year from the original due date of the return (determined without regard to any extensions).
3. Once the taxpayer chooses to exclude their foreign earned income or foreign housing costs, they cannot take a foreign tax credit for taxes on income excluded. If the taxpayer does take the credit, one or both of the choices may be considered revoked.
4. The housing exclusion applies only to amounts considered paid for with employer-provided amounts. The housing deduction applies only to amounts paid for with self-employment earnings.
5. Housing expenses include reasonable expenses paid or incurred for housing in a foreign country for the taxpayer, spouse and dependents (assuming the spouse and dependents are living with the taxpayer).
6. The housing deduction cannot be more than the foreign earned income minus the total of the foreign earned income exclusion plus the housing exclusion.
7. For 2006 and forward, a taxpayer who claims a foreign income exclusion must compute his tax using the FEIE Worksheet which computes the tax at the effective rates that taxpayer would have been in had he not claimed the exclusion.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

International Technical Training

Chapter 8

Statute of Limitation Issues

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk
Participant References	• None
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides • Flipcharts and markers

Overview

Introduction

A Statute of Limitations is a time period allowed by law to review, analyze and resolve IRS related issues.

You are responsible to protect the **Assessment Statute Expiration Date** (ASED).

If a statute expires while a return is in your possession, and the expiration of the statute was not authorized by management, you will be subject to disciplinary action which could include **losing your job**.

- We must **be aware** of and protect the statute on all returns under your control at all times.

Objectives

At the end of this lesson, you will be able to:

- Determine the assessment statute expiration date (ASED) for filed returns.
- Determine the ASED for those circumstances which are an exception to the general rule for the three-year statute.

Continued on next page

Contents

This lesson covers the following topics:

Introduction

Instructor Notes

May use a PowerPoint presentation to present this chapter.

See PowerPoint slides 3, 4, 5, 6, and 7.

Determine the Filing Date

To determine the statute look at the following:

- Postmark date
- Date stamp received on return
- Date noted on the ERCS/AIMS database for the ASED.
- If the return is filed electronically including E-File, the date of the **electronic return transmitter** is deemed to be the received date of the return

---

When is a Return Considered Filed?

If the Return is filed before its due date without regard to any extension, the period of time for the assessment of tax begins to run from the due date of the return.

If the Return is filed after its due date, the period of time for the assessment of tax begins to run from the date the return is received. Exception is the mailbox rule:

- Timely mailed is timely filed.

Normal Three-Year Rule – IRC § 6501(a)

Instructor Notes

Please have the students read and explain IRC § 6501(a) since this is an important code section. See also PowerPoint slide 8.

Read

IRC § 6501 (a).

General Rule

Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within three years after the return was filed. Assessment of tax is a prerequisite to the collection of tax.

If the ASED has expired, the IRS is barred from assessing and collecting additional (new) taxes and the taxpayer is barred from paying additional (new) taxes.

Claims for Credit or Refund

Instructor Notes

See PowerPoint slides 9 and 10.

General Time Period

A claim is a request by the taxpayer for a refund of assessed tax that has been fully paid.

Claims for refund must be filed timely. Claims for credit or refund must be filed within the later of:

- 3 years of the filing of the return, or
- 2 years from the payment of the tax.

Claims for refund do not extend the statutory period for assessing additional tax; therefore, consider asking the taxpayer to sign Form 872 extending the ASED for the years of the claim.

Note: Adjustments can only be made to the extent of the unpaid claim.

Read

IRC § 6511(d) (3).

Foreign Taxes Paid or Accrued

There is a special period of limitation with regard to foreign taxes paid or accrued. If a claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any U.S. possession for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of IRC § 901 or the provisions of any treaty to which the U.S. is a party, then in lieu of the 3-year period of limitations prescribed in IRC § 6511(a), the period of limitations shall be 10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued.

Extension by Consent –IRC § 6501(c) (4)

Instructor Notes

Please have the students read and explain IRC § 6501(c) (4) since this is an important code section. See also PowerPoint slide 8.

Read

IRC § 6501(c) (4).

Extension by Consent – IRC § 6501(c) (4)

The ASED can be extended by the taxpayer and the IRS by agreeing to an extension to a specific date and by signing Form(s) 872 – Consent to Extend the Time to Assess Tax.

IRC § 6501(c) (4) is only applicable if the assessment period is open at the time both parties sign the extension.

For Joint tax returns, each spouse has his/her own separate assessment period. Thus, each spouse must sign the consent. The signature of one spouse does not extend the ASED for the other spouse.

If the taxpayer refuses to sign an extension form and the ASED is about to expire, you should consider:

- Allowing the ASED to expire with managerial approval
- Issue a 90-day letter on all issues not resolved
- Close the case based on the available information.

Exception to the Three-Year Rule- IRC § 6501(e)

Instructor Notes

Please have the students read and explain IRC § 6501(e) since this is an important code section. See also PowerPoint slides 12 and 13.

Read

IRC § 6501(e).

Six Year Rule – IRC § 6501(e)

This is the exception to the three-year rule of IRC § 6501(a).

Substantial Omission of Items:

- **IRC § 6501(e) (1) (A)** General rule — If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.
- **IRC § 6501(e)(1)(A)(i)** In the case of a trade or business, the term **gross income** means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.
- **IRC § 6501(e) (1) (A) (ii)** In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Filing a correct amended return does not shorten the six-year rule if it applied to the original return. *Houston v. Commissioner, 38 T.C. 486 (1962).*

False or Fraudulent Returns – IRC § 6501(c)

Instructor Notes

Please have the students read and explain IRC §§ 6501(c) (1), (c) (2), (c) (3) since these are important code sections. See also PowerPoint slides 14, 15, and 16.

Read

IRC § 6501(c).

False or Fraudulent Return – IRC § 6501(c)

Fraud exception to Three-Year Rule:

There is no ASED If:

- **IRC § 6501(c)(1)** False return — In the case of a false or fraudulent return with the **intent to evade tax**, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.
- **IRC § 6501(c)(2)** Willful attempt to evade tax — In case of a willful attempt in any manner to defeat or evade tax imposed by this title (other than tax imposed by subtitle A or B), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.
- **IRC § 6501(c) (3) No return** — In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.
- Filing of non-fraudulent amended return after a fraudulent return does not eliminate fraud exception to three-year rule. *Badaracco v. Commissioner, 464 U.S. 386 (1984)*.
- IRS has burden of proving fraud before fraud exception to three-year rule can be applied.

Failure to File Foreign Information Returns (Including HIRE Act Provisions) – IRS § 6501(c) (8)

Instructor Notes

Please have the students read and explain IRC § 6501(a) since this is an important code section. See also PowerPoint slides 12 and 13.

Failure to File Foreign Information Returns (Including HIRE Act Provisions) IRC § 6501(c)(8)

In general, under IRC § 6501 (a), the IRS has three years from the filing of a tax return to assess additional tax. This ASED also applies to information required to be reported on Forms 5471, 5472, 926, 8865, 3520, and 3520A with regard to certain foreign transactions.

The ASED determined under IRC § 6501(c) (8) is three years after the date the required information is furnished. This ASED can be extended by consent agreement but only applies to the period for assessing the tax liability related to the transaction/event for which information is furnished.

However, if Forms 5471, 5472, 926, 8865, 3520, or 3520A were not filed, or were filed but were not complete and accurate, then there is no Statute of Limitation.

2010 Hiring Incentives to Restore Employment Act (HIRE Act)

The 2010 Act amends the IRC § 6501(c)(8) rule to state the information required to be reported, and that the ASED with respect to any "tax return, event, or period" to which that information relates will not expire before the date that is three years after the date the required information is furnished.

By adding the words "tax return", the ASED is extended to all items on the return even if they are unrelated to the items causing the extension.

Very Important On Offshore Examination

- This applies when the failure to file was due to **willful neglect** which can be inferred in the investigation of most offshore structures – which were designed with the specific intent to avoid or evade reporting responsibilities.
- If the failure to report the information is due to **reasonable cause**, the extension of the ASED only applies to the item or items related to the failure.

This new rule applies to any tax returns filed after March 18, 2010.

Examining Barred Tax Years – Closing Agreement

Instructor Notes

Please have the students read and explain IRM 8.13.1.1. See also PowerPoint slide 22.

Read

IRM 8.13.1.1

Effect of Closing Agreement on Statute of Limitation

A closing agreement is a signed agreement between the Service and one or more taxpayers, relating to the liability of the taxpayer(s) for a specified tax, penalties, and interest for one or more specified tax periods. A closing agreement is authorized under IRC § 7121, and must meet all of the requirements of that section which provides that closing agreements may not be reopened or modified by any officer, employee, or agent of the U.S. in the absence of fraud, malfeasance or misrepresentation of a material fact. In effect, a closing agreement brings finality to the issues agreed upon in the agreement.

Types of Closing Agreements – IRM 8.13.1.1.2

There are three different types of closing agreements:

1. Form 866, Closing Agreement as to Final Determination of Tax Liability.
2. Form 906, Closing Agreement as to Final Determination Covering Specific Matters.
3. Combined Agreement (modified Form 906).

In cases in which there is a deficiency or over assessment, a Form 870 or other waiver should also be secured from the taxpayer(s), even though such a waiver may not be legally required in every case.

Continued on next page

Statute of Limitation Issues

Regardless of who is authorized to execute the closing agreement, responsibility for protecting the statute of limitations will remain in the recommending office, if it had such responsibility immediately before forwarding the agreement. When the statute of limitations for a period (or return) involving a closing agreement will expire within 120 days from the date the agreement is to be submitted, the taxpayer will be advised that the closing will not be forwarded unless a consent is signed extending the statute to a date at least 180 days after the agreement is signed by the taxpayer or 120 days after the agreement is submitted, whichever is later.

To comply, consents will be secured to cover years for which over-assessments are proposed.

Instructor Notes

Please have the students read and explain IRM 8.13.1.7.1. See also PowerPoint slides 24, 25, and 26.

Read

IRM 8.13.1.7.1

Examining Barred Years – IRM 8.13.1.7.1

When a legal tax assessment is not made timely within the prescribed period for assessment – ASED- it is considered a “barred assessment”.

- However, the IRS can examine returns after the normal three-year rule has expired – *U.S. v. Powell 379 US 48.*

The IRS can also use IRC §§ 6501 (c) (1), (c) (2), (c) (3), and (c) (8) to examine the barred tax years.

Continued on next page

Barred Statute of Limitation

The matter of whether or not a closing agreement determining tax liability for barred years is effective and enforceable is not clearly covered by the statute, regulations or judicial precedent. Existing authority indicates that such an agreement is valid.

The statute clearly points out the instances in which the agreement may be questioned. They are for fraud, malfeasance and misrepresentation. It does not say that such an agreement may be overturned upon a showing that a part, or all, of the taxes paid were assessed after they were barred by limitation.

If tax liability is at issue for a year barred (or arguably barred) by expiration of the statutory period of limitations, an agreed upon disposition of the year involving a deficiency without application of the fraud penalty should be finalized by use of a closing agreement determining tax liability for such year.

A closing agreement only determines the matters contained therein, and the statute of limitations issue must be resolved in the agreement itself; otherwise, a taxpayer could challenge the timeliness of the assessment even though it would be precluded by the closing agreement from challenging the amount.

Tax liability can be assessed on barred years if the taxpayer consents to the assessment and waives all defenses against and restrictions on the assessment including any defense based on the expiration of the period of limitations on assessment or collection by signing a closing agreement.

Alpha Codes for Statutes

Introduction

When working cases with barred years, you should update the statute on these cases to an appropriate alpha code.

An ASED should not be updated to an Alpha code on ERCS with more than 180 days remaining on the assessment period.

Form 895 is required on all tax returns where the ASED will expire within 180 days.

Alpha code – AA

AA designates that a claim for refund/credit was filed timely by the taxpayer and there are not other “general” issues on the return and the claim has not been paid. The timely filing of a claim does not extend the period for assessing tax.

Alpha Code – AB

AB designates that the statutory limitation for the period for assessment of tax has been waived by a closing agreement that has been properly executed by both the taxpayer and the IRS.

Alpha Code – BB

BB designates a net operating loss or capital loss carryback situation where the statute expiration date is determined by the statute date of the loss year return. BB may be used where the taxpayer has filed a loss carryback claim and the claim has been paid and in other situations where a loss carryback adjustment is determined.

Alpha Code – EE

EE designates that no return has been filed by the taxpayer; therefore, there is no statute expiration date – IRC § 6501(c) (3).

When a late filed return is received from a taxpayer, alpha code EE will be updated with a true statute expiration date based on the date the return was received by the Service.

Alpha Code – NN

NN is used to indicate that the Service is relying on a substantial omission of items meeting the requirements of either IRC§ 6501(e) (1), (e) (2) or (e) (3). The tax may be assessed within 6 years after the date the original return was filed or due, whichever is later. The burden of proving omission of items is on the government.

Continued on next page

Alpha Code – OO

OO is used when the Service is relying on the provisions of IRC § 6501(c) (1), relating to the filing of a false or fraudulent return with the intent to evade tax, to keep the statute open. If fraud is proven, there is no limit on the period of time for assessment. If the original return is fraudulent, an increase in the tax liability can be assessed at any time.

Alpha Code – RR

RR is used when another code section overrides IRC § 6501(a) and the special statute condition is not otherwise designated by another ASED alpha code. If RR is used, Form 895 must reflect which particular IRC section applies and why.

An example of an IRC section which overrides § 6501(a) is IRC 905(c) under which a taxpayer does not notify the IRS of a change in foreign tax. The RR code indicates that the statutory period for assessment is extended until receipt of notification from the taxpayer.

Alpha Code – UU

UU is used to indicate that the assessment of tax with will not expire until three years after information required to be reported under IRC §§ 6038. 6038A, 6046A or 6048 is furnished and reported on Forms 5471, 5472, 926, 8865, 3520, and 3520A.

The Hire Act of 2010:

By adding the words “tax return”, the ASED is extended to all items on the return even if they are unrelated to the items causing the extension.

This new rule applies to any tax returns filed after March 18, 2010.

Alpha Code – YY

Generally, the YY ASED alpha code should only be used for tax returns filed by participants in abusive offshore arrangements where it has yet to be determined whether or not a specific statutory exception to the normal 3-year period of time for assessment of tax applies.

This alpha code may also be used when the normal 3-year period of time for assessment of tax has already expired before the audit of a return involving abusive offshore transactions.

Summary

Instructor Notes

Please see PowerPoint slides 30, 31, 32, and 33.

1. You are responsible for the protection of the Assessment Statute of Limitations.
2. The general rule is the ASED will expire three years from the date the return was filed or the due date which ever is later.
3. There following situations are exceptions to the general rule:
   a) Substantial omission of income
   b) Fraudulent file of tax return
   c) Failure to File tax return

4. Claims for credit or refund must be filed within the later of:
   a) 3 years of the filing of the return, or
   b) 2 years from the payment of the tax.

5. The Statute of Limitation can be extended by the taxpayer.
6. Tax liabilities can be assessed on barred years if the taxpayer consents to the assessment and waives all defenses.
7. This Statute of Limitation also applies to information required to be reported on Forms 5471, 5472, 926, 8865, 3520, and 3520A with regard to certain foreign transactions. However, if these forms were not filed, or were filed but were not complete and accurate, then there is no Statute of Limitation.
8. IRS can use IRC §§ 6501(c) (1), (c) (2), (c) (3), and (c) (8) to examine barred tax years.
9. When working cases with barred tax years, you should update the statute on these cases to an appropriate alpha codes.

Exercises

Exercise #1

Determine the ASED for an individual income tax return with a taxable year ended December 31, 2008 given the following information:

Due Date:	04/15/2009
Postmark:	03/26/2009
Received:	04/01/2009

Answer:

04/15/2012 – The ASED is the due date of the return plus three years following the general rule because the return was filed on or before its due date of 04/15/2009.

Exercise #2

Determine the ASED for an individual income the tax return with a taxable year ended December 31, 2009 given the following information:

Due Date:	04/15/2010
Postmark:	04/14/2010
Received:	04/17/2010

Answer:

04/15/2013 – Even though the return was received after the filing date, the postmark on the return envelope was postmarked on or before the due date, so the ASED is three years from the due date.

Continued on next page

Exercise #3

Determine the ASED for a corporation income tax return with a taxable year ended December 31, 2008 given the following information:

Due Date:	03/15/2009
Filed extension to 09/15/2009:	03/14/2009
Postmark:	07/15/2009
Received:	07/18/2009

Answer:

Even though the taxpayer had until 09/15/2009 to file the return to have it considered timely, the statute date, per IRC § 6501(a), is three years after the return was filed. Since the return was received on 07/18/2009, the ASED will expire three years from the received date. The postmark is not considered because it was postmarked after the due date of the return not considering extensions.

Exercise #4

If the taxpayer timely filed his 2008 Federal Income Tax Return on April 15, 2009, but did not pay tax due until October 15, 2011, when is the last day the taxpayer can file a claim for refund?

Answer:

10/15/2013 – Claims for credit or refund must be filed within the later of:

- 3 years of the filing of the return, or
- 2 years from the payment of the tax.

In this case the later date is 2 years from the payment of the tax.

Continued on next page

Exercise #5

The taxpayer filed his 2008 tax return timely. He reported gross receipts of $2,000,000 on his schedule C before reduction of cost of goods sold which were reported as $1,250,000. An informant's report indicated the corporation had failed to report gross income in the amount of $500,000.

What is the ASED of this return?

Answer:

04/15/2012 – IRC § 6501(c) allows a six-year period for assessment of tax on a return filed that has omitted **over 25%** of gross income not considering cost of goods sold. The facts of the above scenario has the corporation omitting 25% of gross income ($2,000,000 X 25% = $500,000). Since the omission was **not more than 25%,** the six-year assessment period does not apply.

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International Technical Training

Chapter 9

Foreign Tax Credit

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 8 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide

Overview

Introduction

The United States taxes its citizens and residents on their worldwide income. Worldwide income includes income from sources inside and outside of the U.S. The foreign tax credit (FTC), which is provided by IRC § 901, is designed to relieve U.S. taxpayers of the burden of double taxation when foreign income is taxed by both the U.S. and the foreign country from which it is derived. The foreign tax credit reduces a taxpayer's U.S. tax liability by all or part of the foreign taxes paid or accrued during the tax year. The credit is generally the lesser of the foreign tax paid or the U.S. tax on the foreign income.

In general, if the tax rate in a foreign country is higher than the tax rate in the U.S., the foreign tax credit will offset the U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. tax rates, the taxpayer's U.S. tax liability on the foreign income will be limited to the difference between the two tax rates.

It is important to remember that the foreign tax credit applies only to the tax on foreign sourced income. It cannot be used to offset U.S. tax on U.S. sourced income.

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and PowerPoint slides.

Continued On Next Page

Objectives

At the end of this lesson, the student will be able to:

- Determine who may claim a foreign tax credit.
- Determine what foreign taxes qualify for a credit.
- Explain how exclusions of foreign income under IRC § 911 can affect the foreign tax credit.
- Explain the difference between a foreign tax credit and a foreign tax deduction.
- Explain how an accrual basis taxpayer claims the credit versus a cash basis taxpayer.
- Explain the impact of foreign currency and exchange rates on the foreign tax credit.
- Calculate the foreign tax credit.
- Consider limits to the foreign tax credit.
- Determine if the taxpayer is exempt from the limits to the foreign tax credit.
- Calculate any carryback or carryover of the foreign tax credit.

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Contents

This lesson covers the following topics:

Foreign Tax Credit Code Sections

Code Section	Description
901	**Direct Credit –** Generally a credit resulting from a tax paid to a foreign country by a U.S. taxpayer computed on the basis of net income.
904	**FTC Limitation –** This section limits the amount of usable tax credit available in each year, including carrybacks and carryovers of credits.
905	**Foreign Tax Redeterminations** – This section provides the guidelines on FTC where foreign taxes have been redetermined after the year in which a foreign tax credit was claimed on a U.S. tax return.

Who May Take the Credit

Unlike the foreign earned income exclusion, there is no requirement for a taxpayer to live overseas for any period of time before he or she is entitled to claim a foreign tax credit. U.S. citizens and resident aliens are normally entitled to take a credit for taxes they pay or accrue to a foreign country with respect to foreign sourced income.

Reading Assignment

Read Treas. Reg. § 1.901-1(a).

U.S. Citizens

If taxpayers are U.S. citizens, they are taxed on their worldwide income wherever they live. They are normally entitled to take a credit for foreign taxes paid or accrued.

Resident Aliens

If taxpayers are resident aliens of the U.S., they can take a credit for foreign taxes subject to the same general rules as U.S. citizens.

Exercise 1

Ms. Graves worked in the U.S. for a Japanese corporation. Her annual earnings were $55,000 and her salary was paid directly from Japan. The company withheld $5,000 of her salary and deposited it in a savings account in Japan for her. She earned $484 in interest on this account in 2006.

Ms. Graves also sold stock that she had in a Japanese corporation for a gain of $4,500. Before the stock was sold, she received $750 in dividends from the Japanese corporation.

List Ms. Graves' foreign sourced income.

Wages:	___ NO______________
Interest:	___YES_____________
Capital Gains:	___ NO______________
Dividends:	___YES_____________

What Foreign Taxes Qualify for the Credit

Generally, the following four tests must be met for any foreign tax to qualify for the credit :

1. The tax must be imposed on the taxpayer;
2. The taxpayer must have paid or accrued the tax;
3. The tax must be the legal and actual foreign tax liability; and
4. The tax must be an income tax (or a tax in lieu of an income tax).

The Tax Must Be Imposed on the Taxpayer

A credit can be claimed only for foreign taxes that are imposed on a taxpayer by a foreign country or U.S. Possession. For example, a tax deducted from wages is considered imposed on a taxpayer.

The right to claim the credit cannot be shifted by contract or other means to another person or entity.

A foreign country includes any foreign state and its political subdivisions. For example, war profits tax or excess profits taxes paid to a foreign province qualify for the foreign income tax credit.

For foreign tax credit purposes, all qualified taxes paid to U.S. Possessions are considered foreign taxes. For this purpose, U.S. Possessions include Puerto Rico, Guam, and the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands, and American Samoa.

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The Tax Must Have Been Paid or Accrued

Generally, a taxpayer can only claim the credit if they paid or accrued the foreign tax to a foreign country or U.S. Possession. However, there are ways in which a taxpayer could claim the credit even if they did not pay or accrue the tax themselves.

For example, if a joint return is filed, the credit can be claimed based on the total foreign income taxes paid or accrued by the taxpayer and their spouse.

If the taxpayer is a member of a partnership, or a shareholder in an S corporation, they can claim the credit based on their proportionate share of the foreign income taxes paid or accrued by the partnership or the S corporation. These amounts will be reflected on the Schedule K-1 the taxpayer receives from the partnership or S corporation. However, if the taxpayer is a shareholder in an S corporation that in turn owns stock in a foreign corporation; they cannot claim a credit for their share of foreign taxes paid by the foreign corporation.

If the taxpayer is a beneficiary or an estate or trust, they may be able to claim the credit based on their proportionate share of foreign income taxes paid or accrued by the estate or trust. This amount will be reflected on the Schedule K-1 the taxpayer receives from the estate or trust. The tax must have been imposed on the income of the estate and not on income received by the decedent.

If the taxpayer is a shareholder of a mutual fund, they may be able to claim the credit based on the share of foreign income taxes paid by the fund if it chooses to pass the credit on to its shareholders. The taxpayer should receive from the mutual fund a Form 1099-DIV showing the foreign country or U.S. Possession, their share of the foreign income, and their share of the foreign taxes paid.

Example 1

Victoria worked in Venezuela for an oil company. The foreign government sent Victoria a tax bill of $6,000 directly to her employer. The oil company paid her $6,000 foreign income tax without reporting it in her regular pay. Victoria may claim the $6,000 as a foreign tax available for credit as though she had paid the amount herself, but she must also include the $6,000 as additional income.

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Tax Must Be the Legal and Actual Foreign Tax Liability

The amount of foreign tax that qualifies is not necessarily the amount of tax withheld by the foreign country. Only the legal and actual foreign tax liability that was paid or accrued during the year qualifies for the credit.

A foreign tax credit cannot be taken for income taxes paid to a foreign country if it is reasonably certain the amount would be refunded, credited, rebated, abated, or forgiven if a claim is made.

The United States has treaties with many countries allowing U.S. citizens and residents reductions in the rates of tax of those foreign countries. However, some treaty countries require U.S. citizens and residents to pay the tax figured without regard to the lower treaty rates and then claim a refund for the amount by which the tax actually paid is more than the amount of tax figured using the lower treaty rate. The qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, since the excess tax is refundable.

Example 2

Diane is a shareholder of a Swiss corporation. She received a $10,000 dividend from the corporation and had $3,500 (35%) in Swiss taxes withheld from the dividend. The amount of tax due under the tax treaty with Switzerland is $1,500 (15%). She is eligible to request a refund from the Swiss government for the amount in excess of the treaty rate ($2,000). The amount of creditable tax is limited to the treaty rate of 15% or $1,500 foreign tax.

Reading Assignment

Read IRC § 903(a).

Tax Must Be an Income Tax (or Tax in Lieu of Income Tax)

Generally, only income, war profits, and excess profits taxes (income taxes) qualify for the foreign tax credit. Foreign taxes on wages, dividends, interest, and royalties generally qualify for the credit.

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Income Tax

Simply because a levy is called an income tax by the foreign taxing authority does not make it an income tax for this purpose. A foreign levy is an income tax only if it meets both of the following tests:

1. It is a tax; that is, it must be paid and there is no specific economic benefit from paying it.
2. The predominant character of the tax is that of an income tax in the U.S. sense.

A foreign levy may meet these requirements even if the foreign tax law differs from U.S. tax law. The foreign law may include in income items that U.S. law does not include, or it may allow certain exclusions or deductions that U.S. law does not allow.

Taxes Not Based on Income

Foreign taxes based on gross receipts or on the number of units produced, rather than on realized net income; do not qualify unless they are imposed in lieu of an income tax. Taxes based on assets, such as property taxes; do not qualify for the credit.

Reading Assignment

Read IRC §§ 7701(b) (3) (D), 7701(b) (5) and 7701(b) (7).

Read IRC § 911(d) (6).

Continued on next page

Taxes on Excluded Income

Foreign taxes available for the credit must be reduced by the amount of taxes paid or accrued on income that is excluded from U.S. income under the foreign earned income exclusion or the foreign housing exclusion.

To find the amount allocable to the excluded wages, multiply the foreign tax paid or accrued on foreign earned income received or accrued during the tax year by a fraction. The numerator of the fraction is the foreign earned income and housing amounts excluded for the tax year minus otherwise allowable deductible expenses definitely related and properly apportioned to that income. The denominator is the total foreign earned income received or accrued during the year minus all deductible expenses allocable to that income (including the foreign housing deduction).

Example 3

Charles is a U.S. citizen and a cash basis taxpayer, employed by Charles Co. and living in Canada. His records show the following:

Foreign earned income received	$120,000
Unreimbursed business travel expenses	20,000
Income tax paid to Canada	30,000
Exclusion of foreign earned income and housing allowance	$87,225

Because Charles can exclude part of his wages, he cannot claim a credit for part of the foreign taxes. Charles finds the amount of business expenses allocable to excluded wages and therefore not deductible by multiplying the otherwise allocable deductible expenses by a fraction. The fraction is the excluded wages over the foreign earned income.

$20,000	x	$ 87,225	=	$14,538
		$120,000		

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Taxes on Excluded Income (continued)

Next, Charles finds the numerator of the fraction by which he will multiply the foreign taxes paid. To do this, he subtracts business expenses allocable to excluded wages ($14,538) from excluded wages ($87,225). The result is $72,687. Then, Charles finds the denominator of the fraction by subtracting all his deductible expenses from all his foreign earned income ($120,000 – $20,000 = $100,000). Finally, he multiplies the foreign tax he paid by the resulting fraction.

$30,000	x	$ 72,687	=	$21,806
		$100,000		

The amount of Canadian tax Charles cannot take a credit for is $21,806.

Taxes for Which Only an Itemized Deduction Can Be Claimed

Reading Assignment

Read IRC § 901(j).

A foreign tax credit may not be claimed for income taxes paid or accrued to any country if the income giving rise to the tax is for a period during which:

1. The Secretary of State has designated the country as one of the countries that repeatedly provides support for acts of international terrorism;
2. The United States has severed or does not conduct diplomatic relations with the country; or
3. The United States does not recognize the country's government, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act.

The following countries meet this description for 2008. Income taxes paid or accrued to these countries in 2008 do not qualify for the credit: See Rev. Ruling 2005-3 (the latest published list).

1. Cuba
2. Iran
3. North Korea
4. Sudan
5. Syria

Countries Removed from the Sanctioned List

Country	Starting Date	Ending Date
Iraq	February 1, 1991	June 27, 2004
Libya	January 1, 1987	December 9, 2004
Vietnam	January 1, 1987	July 21, 1995

Choosing to Take a Credit or a Deduction

Reading Assignment

Read IRC § 901(a).

A taxpayer can choose each tax year to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit or as an itemized deduction. The taxpayer can change their choice for each tax year.

To choose the foreign tax credit, a Form 1116 is completed and attached to the U.S. tax return. There is an exception for de minimis foreign tax credits that allows a taxpayer to claim the foreign tax credit without using Form 1116. To claim the taxes as an itemized deduction, Schedule A is used.

Reading Assignment

Read IRC § 275(a) (4).

Choice Applies to All Qualified Foreign Taxes

If a taxpayer chooses to take a credit for qualified foreign taxes, the credit must be taken for all of them. In other words, none of them can be deducted. Conversely, if a taxpayer chooses to deduct qualified foreign taxes, all must be deducted, and none can be taken as a credit.

Continued on next page

Choosing to Take a Credit or a Deduction, Continued

Exceptions for Foreign Taxes Not Allowed as a Credit

Even if a claim is taken for other foreign taxes, a deduction may be taken for any foreign tax not allowed as a credit if:

1. The tax was paid to a country for which a credit is not allowed because it provides support for acts of international terrorism or because the United States does not have diplomatic relations with it or recognize its government.
2. Withholding tax is paid on dividends from foreign corporations whose stock was not held for the required period of time.
3. The taxpayer participated in or cooperated with an international boycott.
4. Taxes were paid in connection with the purchase or sale of oil or gas.

Foreign Taxes That Are Not Income Taxes

Generally, only foreign income taxes qualify for the foreign tax credit. Other taxes, such as foreign real or personal property taxes, do not qualify. But these other taxes may be deducted even if a foreign tax credit is claimed.

Generally, these other taxes can be deducted only if they are expenses incurred in a trade or business or in the production of income. However, foreign real property taxes that are not trade or business expenses may be deducted as an itemized deduction on Schedule A.

Why Choose the Credit?

Although no one rule covers all situations, it is generally better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is because:

1. A credit reduces actual U.S. income tax on a dollar-for-dollar basis, while a deduction reduces only income subject to tax.
2. A credit can be chosen even if the taxpayer does not itemize (assuming the total of the other itemized deductions do not exceed the standard deduction). Thus, the taxpayer then is allowed the standard deduction in addition to the foreign tax credit.
3. If the foreign tax credit is chosen, and the taxes paid or accrued exceed the credit limit for the tax year, a carry back or carry over is available for the excess.

Carryback and Carryover

There is a limit on the credit that can be claimed in a tax year. If qualified foreign taxes exceed the credit limit, the excess may be able to be carried over or carried back to another tax year.

Reading Assignment

Read IRC § 904(c).

Unused foreign taxes arising in tax years beginning after October 22, 2004 can be carried back 1 year and forward 10 years. In addition, the carryforward period has been extended from 5 years to 10 years for unused foreign taxes that could be carried forward under the 5=year rule of prior law.

Under prior law, the carryback period was 2 years and the carryforward period was 5 years.

If, because of the limit on the credit, the full amount of qualified foreign taxes paid or accrued in the tax year cannot be used, a 1-year carryback and then a 10 year carryover of the unused foreign taxes is allowed.

This means that the unused foreign taxes of a tax year can be treated as though the tax were paid or accrued in the 1 preceding and 10 succeeding tax years up to the amount of any excess limit in those years. A period of less than 12 months for which a return is made is considered a tax year.

The unused foreign tax in each category is the amount by which the qualified taxes paid or accrued are more than the limit for that category. The excess limit in each category is the amount by which the limit is more than the qualified taxes paid or accrued for that category.

Carrybacks and carryovers should be figured separately for each separate limit income category.

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Example 5

All of Ed's foreign income is in the general limitation income category. The limit and the qualified foreign taxes paid on the income are as follows:

Year	Your Limit	Tax Paid	Unused foreign tax (+) or excess limit (-)
2005	$200	$100	$(100)
2006	$200	$600	$ 400
2007	$300	$250	$ (50)

In 2006, Ed had unused foreign tax of $400 to carry to other years. Ed is considered to have paid this unused foreign tax first in 2005 (the first preceding tax year) up to the excess limit in that year of $100. Ed can then carry forward the remaining $300 of unused tax forward for up to 10 years.

Effect of Bankruptcy or Insolvency

If the taxpayer's debts are cancelled because of bankruptcy or insolvency, they may have to reduce their unused foreign tax carryovers to or from the tax year of the debt cancellation by 33-1/3 cents for each $1 of cancelled debt that is excluded from gross income. The bankruptcy estate may have to make this reduction if it has acquired the unused foreign tax carryovers. Also, the taxpayer may not be allowed to carry back any unused foreign tax to a year before the year in which the bankruptcy case began.

Reading Assignment

Read IRC § 6511(d) (3).

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Making or Changing the Choice

A choice can be made or changed to claim a deduction or credit at any time during the period within 10 years from the due date for filing the return for the tax year for which the claim is made. The choice can be made or changed on the tax return (or amended return) for the year the choice is to be effective.

Example 6

Adam paid foreign taxes for the last 13 years and chose to deduct them on his U.S. income tax returns. He was timely in both filing his returns and paying his U.S. tax liability. In February 2007, he filed an amended return for tax year 1996 choosing to take a credit for his 1996 foreign taxes because he now realized that the credit is more advantageous than the deduction for that year. Because his return for 1996 was not due until April 15, 1997, his choice is timely (within 10 years).

Because there is a limit on the credit for his 1996 foreign tax, he has unused 1996 foreign taxes. Ordinarily, he would first carry back unused foreign taxes and claim them as a credit in the 2 preceding tax years; also, if he was unable to claim all of them in those 2 years, he would carry them forward to the 5 years following the year in which they arose.

Because Adam chose to deduct his foreign taxes and the 10-year period for changing the choice for 1994 and 1995 has passed, he cannot carry the unused 1996 foreign taxes back to tax years 1994 and 1995.

Because the 10-year period has not passed for his 1997 through 2001 income tax returns, Adam can still choose to carry forward any unused 1996 foreign taxes. However, he must reduce the unused 1996 foreign taxes that are carried forward by the amount that would have been allowed as a carry back if he had timely carried back the foreign tax to tax years 1994 and 1995.

Credit for Taxes Paid or Accrued

A credit can be claimed for a qualified foreign tax in the tax year in which it is paid or accrued, depending on the taxpayer's method of accounting. "Tax year" refers to the tax year for which the U.S. tax return was filed, not the tax year for which the foreign return is filed.

Accrual Method of Accounting

If an accrual method of accounting is used by the taxpayer, the credit may be claimed only in the year in which the taxpayer accrues the tax. Foreign taxes generally accrue when all the events have taken place that fix the amount of tax and the taxpayer's liability to pay for it. If a foreign tax liability is being contested, it cannot be accrued, and a credit cannot be taken until the amount of foreign tax due is finally determined. However, if the taxpayer chooses to pay the tax liability being contested, he can take a credit for the amount paid before a final determination of foreign tax liability is made. Once the final tax liability is determined, the foreign tax credit is allowable for the year to which the foreign tax relates. If the amount of foreign taxes taken as a credit differs from the amount of the final tax liability, the credit will need to be adjusted.

Reading Assignment

Read IRC § 905(c) (4); Treas. Reg. § 1.905-2(c).

Cash Bond

If a taxpayer claims a credit for foreign taxes accrued but not paid, the Service may request that the taxpayer post an income tax bond to guarantee payment of any taxes due in the event the amount of foreign taxes ultimately paid differs from the amount claimed. The bond, filed on Form 1117, must be in whatever amount the Service determines necessary to protect its right to any tax resulting from a redetermination of the credit.

Reading Assignment

Read IRC § 905(a).

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Choosing to Take Credit in the Year Taxes Accrue

Even if the cash method of accounting is used, a credit may be claimed for foreign taxes in the year accrued. This choice is made on the Form 1116. Once the choice is made, it must be followed in all later years.

In addition, the choice to take the credit when foreign taxes accrue applies to all foreign taxes qualified for the credit. A credit cannot be claimed for some foreign taxes when paid and a credit taken for others when accrued.

10-Year Time Limit on Refund Claims

There is a special 10-year time limit to file claims for refund of U.S. tax where foreign taxes actually paid or accrued exceed the amount originally claimed.

The 10-year period applies to claims for refund based on:

- Fixing math errors in figuring qualified foreign taxes,
- Reporting qualified foreign taxes not originally reported on the return, or
- Any other changes in the size of the credit including changes caused by correcting the foreign tax credit limit.

The special 10-year limit also applies to making or changing the choice of whether to claim a deduction or credit for foreign taxes.

Foreign Currency and Exchange Rates

U.S. income tax is imposed on income expressed in U.S. dollars, while foreign taxes are normally expressed in foreign currencies. Therefore, the foreign tax credit is affected when foreign currencies depreciate or appreciate in terms of the U.S. dollar.

Rate of Exchange for Foreign Taxes Paid

The rate of exchange in effect on the date foreign taxes were paid to the foreign country should be used, unless an exception applies. If tax was withheld in foreign currency, the rate of exchange in effect for the date in which tax was withheld should be used. If foreign estimated tax payments are made, the rate of exchange in effect on the date in which the estimated tax was paid should be used.

The following exception should be considered. If a taxpayer claims a credit for foreign taxes on an accrual basis, they must generally use the average exchange rate for the tax year to which the taxes relate. This rule applies to accrued taxes relating to tax years beginning after 1997 and only under the following conditions:

1. The foreign taxes were paid on or after the first day of the tax year to which they relate, but not later than 2 years after the close of that tax year.
2. The foreign taxes are not paid in an inflationary currency.

For all other foreign taxes, the exchange rate in effect on the date of payment should be used.

Foreign Tax Redeterminations

Reading Assignment

Read IRC § 905(c).

A foreign tax redetermination is any change in the foreign tax liability that affects the U.S. foreign tax credit claimed.

The time of the credit remains the year to which the foreign taxes paid or accrued relate, even if the change in foreign tax liability occurs in a later year.

If a foreign tax redetermination occurs, a redetermination of U.S. tax liability is required in the following situations.

Tax Years After 1997

For tax years beginning after 1997, a redetermination of U.S. tax liability is required if:

1. The accrued taxes when paid differ from the amount claimed as a credit,
2. The accrued taxes claimed as a credit in one year are not paid within 2 years after the end of that tax year, or
3. The foreign taxes paid are refunded in whole or in part by the foreign taxing authority.

Note that if 2. applies, the taxpayer will not be allowed a credit for the unpaid taxes until they pay them. When the accrued taxes are paid, they must be translated into U.S. dollars using the exchange rate as of the date they were paid. The foreign tax credit is allowed for the year to which the foreign tax relates.

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Notice to the IRS of Re-determination

A Form 1040X and a revised Form 1116 must be filed for the tax year affected by a redetermination of foreign taxes. The Service will determine the U.S. tax liability for the year(s) affected. If less foreign taxes are paid than originally claimed as a credit, Form 1040X and Form 1116 must be filed within 180 days after the redetermination occurred. There is no limit on the time the IRS has to redetermine and assess the correct U.S. tax due. If more foreign taxes were paid than what was originally claimed, the taxpayer has 10 years to file a claim for refund.

Failure-to-Notify Penalty

If the Service is not notified of a foreign tax redetermination and the taxpayer cannot show reasonable cause for the failure, a penalty is applicable. For each month, or part of a month, that the failure continues, the penalty is 5% of the tax due resulting from a redetermination of U.S. tax. The penalty cannot be more than 25% of the tax due.

Foreign Tax Refund

If a foreign tax refund is received without interest from the foreign government, no interest will have to be paid on the amount of tax due resulting from the adjustment to the U.S. tax for the time before the date of the refund. However, if a foreign tax refund is received with interest, interest must be paid to the Service, up to the amount of interest paid by the foreign government. The interest payable cannot be more than the interest the taxpayer would have had to pay on unpaid taxes.

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Foreign Tax Imposed on a Foreign Refund

If the foreign tax refund is taxed by the foreign government, the taxpayer cannot take a separate credit or deduction for this additional foreign tax. However, when the foreign tax credit is refigured for the original foreign tax, the amount of the refund can be reduced by the foreign tax paid on the refund.

Example 7

Tom paid foreign income tax of $3,000 in 2005, and received a foreign tax refund of $500 in 2007 on which a foreign tax of $100 was imposed. When Tom refigures his credit for 2005, he must reduce the $3,000 he paid by $400.

How to Compute the Credit

Reading Assignment

Read IRC § 904(a).

The foreign tax credit can be claimed only for qualified foreign taxes paid or accrued by a taxpayer who reports foreign source income on his U.S. return. However, the full amount of foreign income tax paid or accrued will not necessarily be the amount of the taxpayer's foreign tax credit for the tax year. The allowable credit is the lesser of: (1) the amount paid or accrued; or (2) the overall limit on the foreign tax credit.

The overall limit treats all foreign income as a single unit and limits the credit to the U.S. income tax attributable to the taxable income from all sources outside the United States. Under this limit, operating losses in one foreign country will offset income from another foreign country.

Example 8

Albert is a U.S. citizen who had personal service income from Italy of $1,000 and a loss from doing business in Sweden of $2,000. Albert had taxable income from the U.S. of $60,000 before exemptions. Assume that Albert has a U.S. income tax liability of $23,300, an Italian tax liability of $600, and no tax liability for Sweden. Because the loss in Sweden exceeded the income from Italy, Albert has no net taxable foreign income and may claim no credit for the $600 in taxes he paid to Italy.

The overall limit on the foreign tax credit is figured using the ratio of the taxpayer's foreign taxable income to total taxable income. This percentage is then applied to the regular U.S. tax liability to determine the overall limit on the foreign tax credit. The "overall limit" can be expressed by the following formula:

$$\frac{\text{Foreign Taxable Income}}{\text{Total Taxable Income}} \times \text{U.S. Tax Liability} = \text{Maximum Amount}$$

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Example 9

Mabel earned $2,000 for services performed in China for two months. She also earned $10,000 for services performed in the U.S. for the remaining 10 months of the year. She had no other income. Her regular U.S. tax liability was $1,750.

$$\frac{\$\ 2{,}000}{\$12{,}000} \times \$1{,}750 = \$292 \text{ Maximum Foreign Tax Credit.}$$

This is a simplified example to show the basic theory of the foreign tax credit overall limit. If the taxpayer has no taxable foreign income, the numerator of the formula would be zero and there would be no foreign tax credit allowable.

The taxpayer cannot claim a credit for an amount greater than the foreign tax actually paid or accrued. In the last example, if Mabel had paid only $200 of foreign taxes, she could claim credit for only $200. The $292 overall limit represents the maximum amount that can be claimed. If the taxpayer's tax payment or accrual does not exceed the limit, there is no tax available for carryback or carryover. If Mabel had paid $300 of foreign taxes for that year, her limit would be $292, and she could use the remaining $8 as a carryback or carryover.

Example 10

Harry has worldwide taxable income of $80,000 and a tentative U.S. tax liability of $24,800. From his business in Mexico, Harry had $30,000 of taxable income on which Mexico imposed a 30% tax, and from his operations in Thailand, Harry had $20,000 of taxable income on which a 20% tax was imposed. To compute Harry's foreign tax credit limitation, Harry must multiply his U.S. tax by his taxable income from foreign sources ($50,000) divided by his worldwide taxable income ($80,000). Thus, Harry's foreign tax credit limitation is limited to $15,500 ($24,800 × ($50,000/$80,000)).

Limit on the Credit

Reading Assignment

Read IRC § 904(d).

To determine the limit, foreign source income must be separated into various categories of income. The limit treats all foreign income and expenses in each separate category as a single unit and limits the credit to the U.S. income tax on the taxable income in that category from all sources outside the United States.

A separate Form 1116 is required for each of the following categories of income:

1. Passive Income
2. High Withholding Tax Income
3. Financial Services Income
4. Shipping Income
5. Certain dividends from a domestic international sales corporation (DISC) or former DISC.
6. Certain distributions from a foreign sales corporation (FSC) or former FSC.
7. Any lump sum distributions from employer benefit plans for which the special averaging treatment is used to determine the tax.
8. Section 901(j) Income
9. Income Re-Sourced by Treaty
10. General limitation income (this is all other income not included in the above categories).

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For tax years beginning after 2006, the following categories of income will be eliminated for purposes of computing the foreign tax credit limit.

1. High Withholding Tax Interest
2. Financial Services Income
3. Shipping Income
4. Dividends from a domestic international sales corporation (DISC) or former DISC
5. Certain distributions from a foreign sales corporation (FSC) or former FSC

Passive Income

Generally includes dividends, interest, rent, royalties, annuities, net gain from sale of non-income-producing investment property or property that generates passive income, net gains from commodities transactions, amounts included as foreign personal holding company income, and amounts from passive foreign investment companies (PFICs).

High Withholding Tax Interest

High withholding tax interest is interest (except export financing interest) that is subject to a foreign withholding tax or other tax determined on a gross basis of at least 5%. If interest is not high withholding tax interest because it is export financing interest, it is usually general limitation income. However, if it is received by a financial services entity, it is financial services income.

Financial Services Income

Financial services income generally is income received or accrued by a financial services entity. This is an entity predominantly engaged in the active conduct of banking, financing, insurance, or similar business. If the taxpayer qualifies as a financial services entity, financial services income includes income from the active conduct of that business, passive income, high-taxed income, certain incidental income, and export financing income, which is subject to a foreign withholding or gross-basis tax of at least 5%.

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Shipping Income

This is income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce or income derived from space or ocean activities. It also includes income from the sale or other disposition of these aircraft or vessels. Shipping income that is also financial services income is treated as financial services income.

DISC Dividends

This dividend income generally consists of dividends from interest charges of domestic international sales corporation (DISC) or former DISC that are treated as foreign source income.

FSC Distributions

These are:

1. Distributions from a foreign sales corporation (FSC) or former FSC out of earnings and profits attributable to foreign trade income; or
2. Interest and carrying charges incurred by an FSC or former FSC from a transaction that result in foreign trade income.

Lump-Sum Distributions

If a foreign source lump-sum distribution (LSD) from a retirement plan is received, and the taxpayer figures the tax on it using the special averaging treatment for LSDs, a special computation must be made.

Section 901(j) Income

This is income earned from activities conducted in sanctioned countries. Income derived from each sanctioned country is subject to a separate foreign tax credit computation. Therefore, a separate Form 1116 must be used for income earned from each such country.

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Limit on the Credit, Continued

Income Re – Sourced by Treaty

If a sourcing rule in an applicable income tax treaty treats any of the following income as foreign source, and the taxpayer applies the treaty, the income will be treated as foreign sourced.

- Certain gains (IRC § 865(h))
- Certain income from a U.S.-owned foreign corporation (§ 904(g)(10))

A separate foreign tax credit limitation for any such income for which benefits are claimed under a treaty must be computed.

General Limitation Income

This is income from sources outside of the United States that does not fall into one of the other separate limit categories previously described. It generally includes active business income as well as wages, salaries, and overseas allowances of an individual as an employee.

De Minimis Foreign Tax Credits

Reading Assignment

Read IRC § 904(j).

An individual with de minimis foreign tax credits may elect to be exempt from the foreign tax credit limitation rules. An individual who makes the election is not required to file Form 1116; the credit is claimed directly on Form 1040. An individual is not required to file Form 1116 to claim the credit if:

1. all of the individual's income is foreign source gross income in the passive category;
2. all income and foreign taxes paid were reported on a qualified payee statement, for example, Form 1099-INT; and
3. total creditable taxes do not exceed $300 ($600 if married filing joint).

An individual who makes the election to be exempt from the foreign tax credit limitation will not be able to carry forward excess foreign tax credits to or from the year for which the election is made.

Example 11

Gwen, who is single, works as a receptionist and earned $21,000 in 2007. From her investment in a mutual fund, she is paid a dividend of $620 from a Germany company in 2007. The German government withheld $93 in taxes on the dividend and reported a dividend to her on Form 1099-DIV. Gwen has no expenses for the year and claims a standard deduction of $4,700. Since Gwen has creditable foreign tax credits of less than $300, she can elect to calculate her foreign tax credit directly on Form 1040. Because Gwen has elected to be exempt from the foreign tax credit limitation, she will not be able to carry over any unused foreign tax credits.

Allocation of Foreign Taxes

If foreign income taxes were paid or accrued for a tax year on income in more than one separate limit income category, the tax should be allocated to the income category to which the tax specifically relates. If the tax is not specifically related to any one category, it must be allocated to tax on each category of income.

This is done by multiplying the foreign income tax related to more than one category by a fraction. The numerator of the fraction is the net income in a separate category. The denominator is the total net foreign income.

Net foreign income is determined by deducting from the gross income in each category and from the total foreign income any expenses, losses, and other deductions definitely related to them under the laws of the foreign country or U.S. Possession. If the expenses, losses, and other deductions are not definitely related to a category of income under foreign law, they are apportioned under the principles of the foreign law.

Example 12

David paid foreign income taxes of $3,200 to Denmark on wages of $80,000 and interest income of $3,000. These were the only items of income on his Denmark return. David had deductions of $4,400 that, under Denmark law, are not definitely related to either the wages or interest income. David's total net income is $78,600 ($83,000 – $4,400).

Because the foreign tax is not specifically for either item of income, David must allocate the tax between the wages and the interest under the tax laws of Denmark. David figures the expenses allocable to wages (general limitation income) as follows:

$80,000	×	$4,400	=	$4,241
$83,000				

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The net wages are $75,759 ($80,000 – $4,241). Next, David figures the expenses allocable to interest (passive income) as follows:

$ 3,000	×	$4,400	=	$159
$83,000				

The net interest is $2,841 ($3,000 – $159). Then, to figure the foreign tax on the wages, David multiplies the total foreign income tax by the following fraction:

$75,759	×	$3,200	=	$3,084
$78,600				

David figures the foreign tax on the interest income as follows:

$ 2,841	×	$3,200	=	$116
$78,600				

Computing the Limit

Before the taxpayer can determine the limit on their credit, they must first figure the total taxable income from all sources before the deduction for personal exemptions. This is the amount shown on line 39 of the Form 1040. Then for each category of income, they must figure their taxable income from sources outside the United States.

Determining Sources of Income

Summary of Source Rules for Income

Item of Income	Factor Determining Source
Salaries, wages and other compensation	Where services performed
Business Income: Personal Services Sale of inventory – purchased Sale of inventory – produced	 Where services performed Where sold Allocation
Interest	Residence of payer
Dividends	Whether a U.S. or foreign corporation
Rents	Location of property
Royalties: Natural resources Patents, copyrights, etc.	 Location of property Where property is used
Sale of real property	Location of property
Sale of personal property	Seller's tax home
Pensions	Where the services were performed that earned the pension
Sale of natural resources	Allocation based on fair market value of product at export terminal. For more information, see Regulations §1.863-1(b).

Employee Compensation

Compensation for labor or personal services (other than for certain fringe benefits) is sourced on a time basis.

Reading Assignment

Read Treas. Reg. § 1.861-4 (b) (2).

Continued on next page

Certain Fringe Benefits

For tax years starting in 2006, compensation received as an employee in the form of the following fringe benefits is sourced on a geographical basis.

Fringe Benefit	Factor Determining Source
Housing, education and local transportation	Location of principal place of work
Tax reimbursement	Location of the jurisdiction that imposed the tax that was reimbursed
Hazardous or hardship duty pay	Location of the hazardous or hardship duty zone
Moving expense reimbursement	Generally the location of the new principal place of work

Multi-Year Compensation

The source of multi-year compensation is generally determined on a time basis over the period to which the compensation is allocable.

Determining Taxable Income from Sources Outside the United States

Deductions Definitely Related to Income

To figure taxable income in each category from sources outside the United States, allocate to specific classes of gross income the expenses, losses, and other deductions that are definitely related to that income.

A deduction is definitely related to a specific class of gross income if it is incurred either:

- As a result of, or incident to, an activity from which that income is derived, or
- In connection with property from which that income is derived.

Home mortgage interest from Schedule A should be apportioned under a gross income method taking into account all income, but excluding income that is exempt under the foreign earned income exclusion. The gross income method is based on a comparison of the gross income a separate income basket with total gross income.

Any residence that is rented is considered a business asset for the period for which it was rented. Apportion the interest for a rental property as directly related to the rental income.

State income taxes are definitely related and allocable to the gross income on which the taxes are imposed. If state income tax is imposed in part on foreign source income, the part of the state tax imposed on the foreign source income is definitely related and allocable to the foreign source income.

If state tax law specifically exempts foreign income from tax, the state taxes are allocable to the U.S. source income.

Continued on next page

Deductions Not Definitely Related to Income

The taxpayer must apportion to their foreign income in each separate limit category a fraction of their other deductions that are not definitely related to a specific class of gross income. If the taxpayer itemizes, these deductions are medical expenses, general sales taxes, and real estate taxes for the home. If the taxpayer does not itemize, this is the standard deduction. The taxpayer should also apportion any other deductions that are not definitely related to a specific class of income.

Gifts to charity made after July 27, 2004 are allocable wholly to U.S. source income. Taxpayers may also elect to apply this rule to gifts to charity made for the 2004 tax year.

For purposes of the allocation, the numerator of the fraction is the gross foreign income in the separate limit category and the denominator is the total gross income from all sources. For this purpose, gross income includes income that is excluded under the foreign earned income provisions.

Do not take the deduction for personal exemptions, including exemptions for dependents, in determining taxable income from foreign sources outside the U.S.

Capital Gains and Losses

Reading Assignment

Read IRC § 904(b) (2).

A taxpayer may have to make the following adjustments to their foreign source capital gains and losses:

- U.S. capital loss adjustment
- Capital gain rate differential adjustment

Before these adjustments are made, the taxpayer must reduce net capital gain by the amount of any gain elected to be included in investment income on line 4e of Form 4952, *Investment Interest Expense Deduction*. The net capital gain is the excess of the net long-term capital gain for the year over any net short-term capital loss for the year.

U.S. Capital Loss Adjustment

The taxpayer must adjust the amount of their foreign source capital gains to the extent that their foreign source net capital gain exceeds the amount of their worldwide net capital gain (the "U.S. capital loss adjustment").

Continued on next page

Capital Gain Rate Differential Adjustment

After the taxpayer has made the U.S. capital loss adjustment, if any, they are generally required to make additional adjustments (capital gain rate differential adjustments) to the foreign source capital gains and losses. However, the taxpayer does not need to make the capital gain rate differential adjustment if they qualified for the rate differential adjustment exception.

If the taxpayer did not qualify for the rate differential adjustment exception, they are required to make a capital gain rate differential adjustment for each separate category capital gain rate group that has a net capital gain or loss. See the section on U.S. capital loss adjustment earlier for instructions on how to determine whether the taxpayer has a net capital gain or loss in a separate category capital gain rate group and to determine the amount of any U.S. capital loss adjustment the taxpayer must make before they can determine their capital gain rate differential adjustments.

How to Make the Adjustment

How the taxpayer makes the capital gain rate differential adjustment depends on whether they have a net capital gain or net capital loss in a separate category capital gain rate group.

Continued on next page

Net Capital Gain in a Separate Category Capital Gain Rate Group

For 2006, if the taxpayer has a net capital gain in a separate category capital gain rate group, they would make the capital gain rate differential adjustment by doing the following:

- For each separate category that has a net capital gain in the 15% capital gain rate group, multiply the amount of the net capital gain by 0.4286.
- For each separate category that has a net capital gain in the 25% capital gain rate group, multiply the amount of the net capital gain by 0.7143.
- For each separate category that has a net capital gain in the 28% capital gain rate group, multiply the amount of the foreign source net capital gain by 0.80.

No adjustment is required if the taxpayer has a net capital gain in a short-term capital gain rate group. The taxpayer should include the amount of net capital gain in any separate category short-term capital gain rate group on line 1 of the applicable Form 1116 without adjustment.

Allocation of Foreign Losses

If the taxpayer has a foreign loss when figuring their taxable income in a separate limit income category, and they have income in one or more of the other separate categories, the taxpayer must first reduce the income in these other categories by the loss before reducing income from U.S. sources.

Example 13

Larry has $10,000 of income in the passive income category and incurs a loss of $5,000 in the general limitation income category. Larry must first use the $5,000 loss to offset $5,000 of the income in the passive category.

How to Allocate

The taxpayer must allocate foreign losses among the separate limit income categories in the same proportion as each category's income bears to total foreign income.

Example 14

Roger has a $2,000 loss in the general limitation income category, $3,000 of passive income, and $2,000 in distributions from a FSC. Roger must allocate the $2,000 loss to the income in the other separate categories. 60% ($3,000/$5,000) of the $2,000 loss (or $1,200) reduces passive income, and 40% ($2,000/$5,000) or $800 reduces FSC distributions.

Loss More Than Foreign Income

If the taxpayer has a loss remaining after reducing their income in other separate limit categories, the taxpayer uses the remaining loss to reduce U.S. source income. When a foreign loss is used to offset U.S. source income, the taxpayer must recapture the loss.

Continued on next page

Re-characterization of Subsequent Income in a Loss Category

If the taxpayer uses a loss in one separate limit category (category A) to reduce the amount of income in another category or categories (category B and/or category C) and, in a later year has income in category A, the taxpayer must, in that later year, recharacterize some or all of the income from category A as income from category B and/or category C.

Example 15

The facts are the same as in the previous example. However, in the next year, the taxpayer has $4,000 of passive income, $1,000 in FSC distributions, and $5,000 of general limitation income. Since $1,200 of the general limitation loss was used to reduce passive income in the previous year, $1,200 of the current year's general limitation income of $5,000 must be recharacterized as passive income. This makes the current year's total passive income $5,200 ($4,000 + $1,200). Similarly, $800 of the general limitation income must be recharacterized as FSC distributions, making the current year's total of FSC distributions $1,800 ($1,000 + $800). The total income in the general limitation category is $3,000 ($5,000 – $1,200 – $800).

U.S. Losses

Allocate any net loss from sources in the United States among the different categories of foreign income after:

- allocating all foreign losses as described earlier,
- recapturing any prior year overall foreign loss as described below, and
- recharacterizing foreign source income as described above.

A net capital loss from sources in the United States is not taken into account in determining the net loss from sources in the United States to the extent that the net capital loss reduced capital gains from sources outside the United States as discussed earlier.

Recapture of Foreign Losses

If there are only losses in the separate limit categories, or if there is a loss remaining after allocating foreign losses to other separate categories, then there is an overall foreign loss. If this loss is used to offset U.S. source income (resulting in a reduction of U.S. tax liability), the loss must be recaptured in each succeeding year in which there is taxable income from foreign sources in the same separate limit category. The overall loss must be recaptured regardless of whether the foreign tax credit is claimed for the loss year.

The loss must be recaptured by treating part of the taxable income from foreign sources in a later year as U.S. source income. In addition, if, in a later year, the property used in a trade or business is sold or otherwise disposed of, gain must be recognized and treated as U.S. source income, even if the disposition would otherwise be nontaxable. The amount treated as U.S. source income reduces the foreign source income, and therefore reduces the foreign tax credit limit.

Separate accounts must be established for each type of foreign loss that is sustained. The balances in these accounts are the overall foreign loss subject to recapture. The balances should be reduced at the end of each tax year by the loss that is recaptured. The taxpayer should attach a statement to their Form 1116 to report the balances (if any) in their overall foreign loss accounts.

An overall foreign loss is the amount by which gross income from foreign sources for a tax year is exceeded by the sum of expenses, losses, or other deductions that are allocated and apportioned to foreign income.

Summary

1. The foreign tax credit is available to United States citizens and resident aliens.
2. To qualify for the foreign tax credit, the foreign tax must be a genuine income tax and not a social insurance levy, imposed on the taxpayer and paid or accrued during the year.
3. No foreign tax credit is allowed on income excluded from United States income tax, such as income excluded by the foreign income exclusion under IRC § 911.
4. Certain foreign income taxes must be deducted and not claimed as a foreign tax credit.
5. Excess foreign tax credit may be carried back and forward.
6. Appropriate currency exchange rates and dates must be used to calculate the amount of foreign tax paid or accrued in United States dollars.
7. The foreign tax credit is calculated separately on different types of foreign income.
8. Bankruptcy may require a reduction of available foreign tax credit carryover.

Instructor Notes

Display and state the *Objectives* again. May use flipcharts, transparency, and Power Point slides.

International Technical Training

Chapter 10

Foreign Tax Credit AMT

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 5 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide
Equipment and Supplies	• Computer projection system and screen • Flipcharts and markers

Overview

Introduction

A taxpayer who is subject to alternative minimum tax is allowed to claim an alternative minimum foreign tax credit in addition to the regular foreign tax credit claimed on his tax return. The alternative minimum foreign tax credit is subtracted from the tentative alternative minimum tax computed on Form 6251 to determine the tentative alternative minimum tax. The tentative alternative minimum tax is then reduced by the taxpayer's regular tax liability to determine the actual alternative minimum tax liability.

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and PowerPoint slides.

Objectives

At the end of this lesson, the student will be able to:

- Compute alternative minimum foreign tax credit.
- Compute alternative minimum foreign tax credit carryback or carryover.

Continued on next page

Overview, Continued

Contents

This lesson covers the following topics:

Reading Assignment

Read text Chapter 11-1 to 11-5 and the Code sections.

Alternative Minimum Foreign Tax Credit (AMT FTC)

The alternative minimum foreign tax credit is like the regular foreign tax credit, but the AMT FTC reduces the tentative minimum tax while the regular foreign tax credit reduces a taxpayer's regular tax.

A taxpayer can only claim an AMT FTC if he has elected to claim the regular foreign tax credit. If he elects to claim a foreign tax deduction for regular taxes, that election will apply for AMT purposes as well, and no AMT FTC is allowable.

The computation of the AMT FTC is done on a separate Form 1116 which should be labeled AMT FTC at the top of the form to distinguish it from the regular Form 1116.

The AMT foreign tax credit is computed using the regular foreign tax credit rules with several modifications.

The first modification is that the amount of the AMT FTC is limited to the portion of the taxpayer's tentative minimum tax that is derived from foreign sourced income. This is very similar to the computation used in the regular foreign tax credit. For AMT FTC purposes, the computation uses the portion of alternative minimum taxable income (AMTI) instead of regular taxable income to compute the credit. IRC § 59(a)(1) (A) and (B) and IRC § 904(a).

Although in many cases the computation of AMTI is similar to the computation of regular taxable income, if tax preference items are shown on Form 6251, it will be necessary to allocate them to either to either U.S. or foreign source depending on whether they are wholly or ratably allocable to either type of income. The concepts that you learned in the regular foreign tax credit chapter will also apply here.

Continued on next page

Example 1

George's AMTI from his Form 6251 is $190,000 and the foreign portion of his AMTI is $50,000. If his gross alternative minimum tax is $40,625, the maximum that he could claim in AMT FTC would be $50,000/190,000 × 40,625 = $10,691.

For years prior to 2005, the second modification is that the AMT FTC cannot exceed more than 90% of the tentative AMT liability (IRC § 59(a) (2)). This limitation on the AMT FTC has been eliminated for tax years beginning in 2005.

The result of the second modification is that a taxpayer whose income is above the AMT exemption threshold and who has no U.S. sourced income and sufficient foreign taxes to offset his entire regular U.S. tax on his foreign sourced income will owe AMT in most situations.

Example: Even if George's gross AMT of $40,625 in the example above was wholly derived from foreign sourced income, the maximum AMT FTC credit that he could claim would be limited to $36,462 ($40,625 × 90% = $36,562) which is 90% of that amount.

Some taxpayers and their representatives take the position that tax treaties that the United States has signed with a foreign country overrule the 90% limitation provided by IRC § 59(a)(2). The IRS position on this issue is that a foreign tax credit allowed by a tax treaty is subject to the limitations of U.S. law and therefore a treaty does not prevent the application of the 90% limitation provided for by IRC § 59(a)(2) (FSA 200110019). This issue has been upheld by the U.S. Tax Court. *See Lindsey v. Commissioner*, 98 T.C. 672 (1992); *Pekar v. Commissioner*, 113 T.C 158 (1999).

Taxes Available for Credit

The computation of the AMT foreign tax credit starts out using the same creditable foreign taxes as the regular foreign tax credit. The amount of taxes available for the credit is also subject to the same reductions for exempt income as in regular foreign tax credit computation.

AMT Foreign Tax Credit Carryback/Carryover

Carryback and carryover of unused AMT FTC's is available in the same manner as with regular foreign tax credit. Any creditable foreign taxes that are available and not used in a current year, either because of the IRC § 904(a) limitation or the 90% limitation, are available to be carried back and forward the same as the regular foreign tax credit. IRC § 904(c).

The taxpayer must keep separate records of his excess taxes available for regular FTC and AMT FTC carryback/carryover. The amounts will not be the same because of the differences in the computations of the credits and the 90% limitation on the AMT FTC.

Like the regular foreign tax credit, the amount of the AMT FTC must be computed separately for each of the income baskets listed in IRC § 904(d) (1).

Example 2

George's regular tax on Form 1040 is $40,000. His total creditable foreign taxes are $12,000 and his regular foreign tax credit limitation is $9,000. His regular foreign tax credit carryover is $3,000 ($12,000 – 9,000). For AMT FTC purposes, his tentative minimum tax is $32,000 and his foreign tax credit limitation is $10,000. His AMT FTC carryover is $2,000 ($12,000 – 10,000).

Summary

1. The AMT FTC is computed on a separate Form 1116 using rules which are similar to the computation of the regular foreign tax credit.
2. For tax years before 2005, the AMT FTC is limited to 90% of the tentative AMT. The limitation on the AMT FTC is eliminated for tax years starting in 2005.
3. Excess foreign taxes available for credit but not used may be carried back and forward according to the rules that apply to the regular foreign tax credit.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

International Technical Training

Lesson 11

Foreign Withholding

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk • Access to Westlaw
Participant References	• IRC, Treasury Regulations
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by Instructor) • Flipcharts and markers

Overview

Introduction

In general, nonresident aliens and foreign entities are taxed on nonbusiness or “passive” income from U.S. sources at a flat rate of 30 percent, without any deduction or other allowances for costs incurred in earning or collecting the income.

Objectives

At the end of this lesson, you will be able to:

- Identify the types of income subject to withholding at source,
- Identify who is responsible for withholding the tax, and
- Determine the correct rate of withholding.

Contents

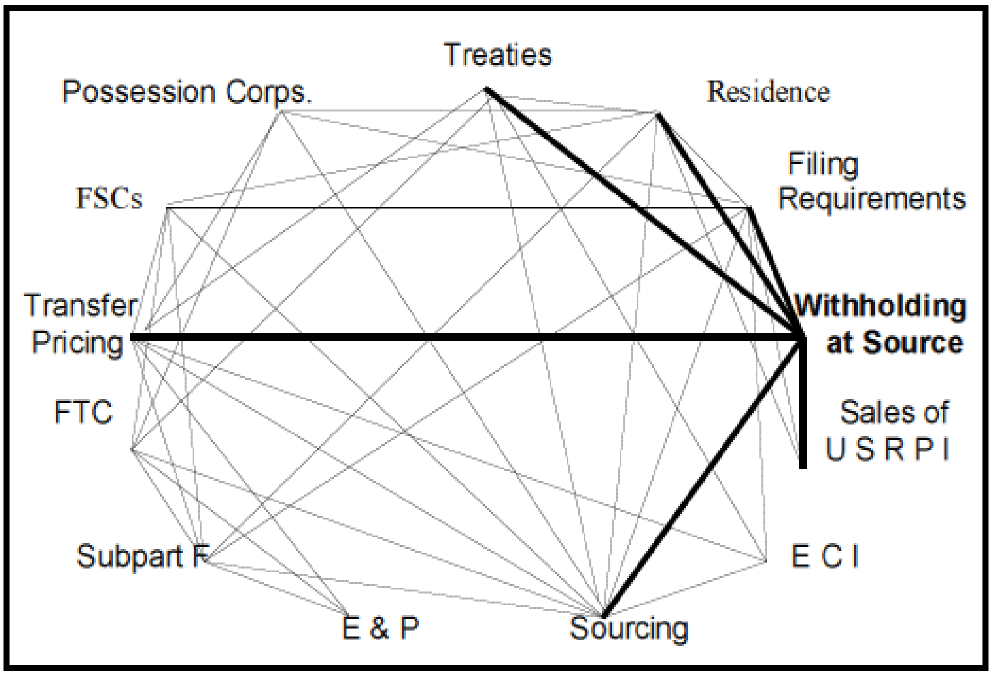
This chapter contains the following topics:

Continued on next page

Relationship to Other Topics

Withholding at source has major relationships with these other topics:

- Treaties
- Residence
- Filing requirements
- Sales of U.S. real property interests
- Sourcing, and
- Transfer pricing.



Treaties, residence, sales of USRPI, sourcing, and transfer pricing determine the requirements for withholding at source. The withholding rules result in additional filing requirements.

Continued on next page

Background

In general, the withholding of tax on NRA (nonresident alien) creates a requirement for U.S. persons to withhold tax and file tax returns. This is because the United States has limited authority to cause NRA earning U.S. sourced nonbusiness income to file tax returns and pay taxes.

These provisions were first enacted as paragraphs D and E of the Revenue Act of 1913, when withholding was required on all nonbusiness income of everyone, resident and nonresident alike. The Revenue Act of 1916 repealed withholding on nonbusiness income of U.S. residents, but withholding for nonresidents has remained in effect since 1913.[1]

The Revenue Act of 1913 called this income "fixed or determinable annual or periodical," (FDAP) and that description remains in the 1986 Code. Many rulings and court decisions since 1913 have confirmed the effectiveness of this catchall phrase.

References

- IRC § § 871, 881, 1441, 1442, and 1461-1464.
- Treas. Reg. § § 1.871-1 through 1.872-2, 1.881-0 through 1.881-4, 1.1441-1 through 1.1442-1, and 1.1461-1 through 1.1464-1.
- Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*.
- Publication 901, *U.S. Tax Treaties.*

Caution

- There have been substantial changes to the regulations affecting withholding of tax at the source for nonresident aliens and foreign entities (NRA) for periods beginning after December 31, 2000.
- In addition, there have been substantial changes to the reporting requirements for periods beginning after December 31, 2000.
- The following text is based upon the Regulations and Filing Requirements for periods beginning after December 31, 2000.

[1] Jeffrey G. Balkin, 341 T.M. U.S. *Income Tax Withholding – Foreign Persons* A-1.

Income Subject to Withholding

General Rule

Generally, the withholding tax is imposed at a flat 30 percent (or lower treaty rate), on the “fixed or determinable, annual or periodical” income (FDAP), without any deduction or allowances for costs incurred in earning or collecting such income. It applies to:

- Interest,
- Dividends,
- Rents,
- Royalties, and
- Other “fixed or determinable annual or periodical” income (FDAP).

But only if the income is:

- An amount received;
- Included in gross income;
- From sources within the United States; and
- Not effectively connected with the conduct of a U.S. trade or business.

Reading Assignment

- Read IRC § 871(a) (1) for the statutory requirement.
  Treas. Reg. § 1.871-2(a) provides that this includes fiduciaries, trusts and estates. IRC § 881 requires the same for foreign corporations.
- Read Treas. Reg. § 1.1441-2(b) for the definition of fixed or determinable annual or periodical income.

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Exceptions for Foreign Governments—IRC § 892(a)

Investment income earned by foreign governments is not subject to U.S. withholding tax. Investment income means income from investments in the United States in:

- Stocks,
- Bonds, or
- Other domestic securities,
- Financial instruments held in the execution of governmental financial or monetary policy, and
- Interest on money deposited by a foreign government in banks in the United States.
- To claim the exemption, the foreign government must provide the payer a Form W-8EXP.

Exceptions for U.S. Possessions

A government of a U.S. Possession is exempt from U.S. tax on all U.S. sourced income.

- Should use form W-8EXP to claim exemption.

Exceptions for International Organizations--IRC § 892(b)

International organizations are exempt from U.S. tax on all U.S. sourced income.

- International organizations are not required to provide a Form W-8, or
- Documentary evidence to receive the exemption if,
- The name of the payee is one that is designated as an international organization by executive order.

Treas. Reg. § 1.892-6T and Treas. Reg. § 1.893-1(b)(3).

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Income Subject to Withholding, Continued

Tax Exempt Exceptions

Withholding at source does not apply to these situations:

- Tax exempt income, for example:
- State and local government bond interest, per IRC § 103, and
- Tax exempt annuities, per IRC § 871(f).

Exceptions for Interest Income

Withholding at source does not apply to these types of interest income:

- Bank interest, per IRC § 871(i),
- Interest paid on bonds sold between interest payment dates, per Treas. Reg. § 1.1441-4(h),
- Short-term OID obligations (for example, commercial paper), per IRC § 871(g), and
- Portfolio interest, per IRC § 871(h).

Definition: Portfolio Interest

Portfolio interest:

- Including both interest, and
- OID on most debt instruments,
  held by persons unrelated to the issuers is exempt from withholding.

- Payments to most related persons, and
- Payments of contingent interest,
  does not qualify as portfolio interest and must be withheld on at the statutory rate of such payments, unless some other exception such as a treaty applies.

Continued on next page

Registration

If an instrument is in registered form:

- The portfolio interest exemption applies only if,
- A statement is given declaring that the beneficial owner is not a U.S. person.

IRC § 871(h)(2(B).

Unregistered

Interest on an obligation that is not registered (bearer obligation) is portfolio interest if the obligation is foreign-targeted. A bearer obligation is foreign-targeted if:

- It can only be sold or resold to non U.S. persons,
- Interest is payable only outside of the U.S. and its possessions,
- The face of the obligation contains a statement that, "Any U.S. person who holds this obligation will be subject to limits under the U.S. income tax laws."

IRC § 871(h)(2(A).

Ten Percent Owners

Interest paid to a foreign person:

- That owns 10 percent or more of the total combined voting power of all classes of stock of a corporation, or
- 10 percent or more of the capital or profits interest in a partnership,
- That issued the obligation on which the interest is paid,
- Is not portfolio interest.

CFC

Interest paid to a Controlled Foreign Corporation from a related person is not portfolio income.

Continued on next page

Residents of Countries Refusing to Supply Information

- If the exchange of information between the United States and a foreign country is not adequate, to prevent evasion of the U.S. income tax by a U.S. person,
- The Treasury may deny the exemption for portfolio interest payable to a person “within” that country, including interest payments addressed to, or for the account of, persons within such foreign country.

IRC §§ 871(h)(6)(A), 881(c)(6).

Exceptions for Dividend Income

A distributing corporation or intermediary may elect to not withhold on the part of the distribution that:

- Represents a nontaxable distribution payable in stock or stock rights,
- Represents a distribution in part or full payment in exchange for stock,
- Is not paid out of current or accumulated E & P,
- Represents a capital gain dividend or an exempt interest dividend by a Regulated Investment Company,
- Is subject to withholding under IRC § 1445 (U.S. Real Property Interest).

Continued on next page

80/20 Company

Generally, a percentage of any dividends paid by a domestic corporation that received at least 80 percent of its gross income from the active conduct of a foreign business for a testing period are not subject to withholding.

The testing period is:

- The three tax years before the year in which the dividends are declared, or
- Shorter period if the corporation was not in existence for three years.

The percentage is found by dividing:

- The corporation's foreign gross income for the testing period by
- The corporation's total gross income for that period.

$$\text{Dividend Percentage} = \frac{\text{Foreign Gross Income for testing Period}}{\text{Corporation Total Gross Income for testing Period}}$$

IRC § 861(c)(1).

Puerto Rico or the Virgin Islands

Dividends paid by a domestic corporation, and

- its main business activities are in Puerto Rico, or
- the Virgin Islands,
- that has chosen the Puerto Rico economic activity credit, or
- the possessions tax credit,
- are not subject to withholding.

Continued on next page

Consent Dividends

A consent dividend is when the shareholder agrees to report a taxable dividend on its own tax return when there is no actual distribution of the consented amount. Shareholder files a Form 972.

The consent dividend provisions apply to corporations that are subject to the:

- Accumulated earnings tax,
- Personal holding companies,
- Foreign Personal Holding Companies,
- Regulated investment companies, and
- Real estate investment trusts.
- Corporation files a Form 973.

Rents

Rents are among the items subject to withholding tax. However, rents are seldom if ever taxed in this manner. IRC § 871(d) allows the election for rents to be treated as effectively connected to a trade or business and taxed at the graduated rates.

Compensation for Services

In general, salaries and wages though listed in IRC § 871(a)(1) as items subject to withholding, are usually effectively connected to a trade or business and not subject to withholding.

Continued on next page

Scholarships

Taxable scholarships and grants received by nonresident:

- Alien students,
- Researchers, and
- Visiting teachers,
- For qualified purposes from a qualified organization,
- Temporarily present in the United States under nonimmigrant visas,
- Deemed to be ECI, and
- If the recipient does not actually have a U.S. trade or business,
- This income is subject to withholding at 14 percent.

Social Security Benefits

The withholding tax applies to 85 percent of any monthly old age, survivors, and disability insurance benefits received by a nonresident alien.

Other FDAP

Other incomes subject to withholding are:

- Royalties,
- Alimony,
- Grants,
- Prizes,
- Awards,
- Gambling winnings, and
- Other.

Continued on next page

Exceptions for Capital Gains

Capital gains are generally exempted from withholding. However, there are a few types of capital gains that are subject to withholding, for example:

- Gains on the sales of intellectual properties, where
- The price is contingent on the properties productivity,
- Use, or
- Disposition.

Treas. Reg. § 1.1441-2(b) (2) (i).

Withholding Agent and Reporting

Rule

The withholding agent is liable for the tax due whether it was withheld or not.

Definition

Treas. Reg. § 1.1441-7(a) defines a withholding agent as anyone who:

- Pays or causes to be paid,
- Any item of income on which withholding is required,
- To or to the agent of any nonresident alien or foreign entity.

Rate

The withholding agent is required to withhold 30 percent of the payment as tax (14 percent regarding scholarships) unless:

- A tax treaty specifies a lower rate, or
- The payment is for the sale of a U.S. real property interest (as provided in IRC §§ 897 and 1445).

Reading Assignment

- IRC §§ 1461-1464 coordinate the responsibility and credit for the tax between the withholding agent and recipient. Read those sections.

U.S. Taxpayer Identification Numbers

Withholding agents must request that the payee provides them with their U.S. taxpayer identification number (TIN).

A TIN must be on a withholding statement (W-8) if the beneficial owner is claiming any of the following:

- Tax treaty benefits,
- Exemption for ECI,
- Exemption for certain annuities, or
- Exemption based on exempt organization or private foundation.

Continued on next page

Reporting

The withholding agent deposits the tax withheld at an authorized financial institution and files an annual withholding tax return on Form 1042 along with information returns for each payee on Forms 1042-S. The withholding agent also gives each payee a copy of his Form 1042-S.

Form 1042 (*Annual Withholding Tax Return for U.S. Sourced Income of Foreign Persons*) is due by each March 15 for the previous calendar year. The statute of limitations, however, expires on April 15; 3 years and 1 month after the due date of the return. The tax returns are filed with the Ogden Campus.

Form 1042-S (*Foreign Person's U.S. Sourced Income Subject to Withholding*) attached to a Form 1042-T (*Annual Summary & Transmittal of Forms 1042-S*) is filed by March 15 to the Ogden Campus and a copy to the NRA (acts much like a form 1099).

Exemption from Withholding

There are four Forms in the W-8 series. The form to use depends on the type of certification being made.

- Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*.
- Form W-8ECI, *Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States*.
- Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding*.
- Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding.*

(These four Forms W-8 are mandatory for periods after 12-31-2000).

- Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.*

Continued on next page

Request for Taxpayer Identification Number

Form W-9 is used only if a U.S. person (including a resident alien) is certifying that the TIN they are providing:

- Is correct, or
- Waiting for a number to be issued,
- Certifying that they are not subject to backup withholding, or
- Claim exemption from backup withholding if they are a U.S. exempt payee.

Beneficial Owner

Rule

The term beneficial owner means the person who is the owner of the income for tax purposes. A person receiving income in a capacity as:

- A nominee,
- Agent, or
- Custodian for another person,
- Is not the beneficial owner of the income.

Foreign Partnerships

The beneficial owners of income paid to a foreign partnership are:

- The partners in the partnership,
- Unless they themselves are not the beneficial owners of the income.

Reading Assignment

- Treas. Reg. § 1.1441-1(c)(6) defines beneficial owner.

Continued on next page

Withholding Certificates

Absent actual knowledge or reason to know otherwise, a withholding agent may consider a payment to be beneficially owned by a foreign person if it can reliably associate the payment with a beneficial owner withholding certificate furnished by the person.
Treas. Reg. § 1.1441-1(c)(16).

A beneficial owner withholding certificate is a statement by which a beneficial owner represents that it is a,

- Foreign person and
- May claim a withholding exemption or a reduced rate.
- The certificate must be on a Form W-8BEN (Form 8233 for Personal Service Income),
- Signed under penalty of perjury, and
- Contain all of the required information.

A beneficial owner withholding certificate must state the beneficial owners TIN if it claims:

- A reduced rate or exemption under an income tax treaty, or
- If it claims that the income is ECI, or
- That the beneficial owner is a tax-exempt organization, or
- A private foundation.

Foreign Intermediaries

Rule

Payments made to a foreign intermediary are treated as if made to the payees on whose behalf the intermediary or entity acts.

Intermediaries

An intermediary means with respect to a payment that it receives, a person that, for that payment, acts as a:

- Custodian,
- Broker,
- Nominee, or
- Otherwise as an agent for another person,
- Regardless of whether such other person is the beneficial owner of the amount paid,
- A flow-through entity,
- Or another intermediary.

Intermediaries are classified as either a:

- Qualified Intermediary (QI), or
- Nonqualified Intermediary (NQI).
- Both file a Form W-8IMY.

Reading Assignment

- Treas. Reg. § 1.1441-1(c) (14) defines Nonqualified intermediary.
- Treas. Reg. § 1.1441-1(e) (5) (ii) defines Qualified intermediary.
- Treas. Reg. § 1.1441-1(e) (5) (iii) Withholding agreement.

Continued on next page

Qualified Intermediary

A Qualified Intermediary (QI) is a person that is a party to a withholding agreement with the IRS and such person is:

- A foreign financial institution or a foreign clearing organization,
- A foreign branch or office of a U.S. financial institution or a foreign branch or office of a U.S. clearing organization.

(See Treas. Reg. § 1.163-5(c) (2) (i) (D) (8) for definition of clearing organization).

Withholding Agreement

The agreement shall:

- Specify the type of certification and documentation,
- Upon which the qualified intermediary may rely,
- To ascertain the classification and status of beneficial owners and payees,
- Who receive payments collected by the qualified intermediary,
- And if necessary, entitlement to the benefits of a reduced rate under an income tax treaty.

(See Rev. Proc. 2000-12 C.B. 2001-1 and Notice 2001-4, for QI agreement and procedures necessary to complete QI application).

Withholding Statement

A withholding statement for a QI must contain the following information:

- Designate those accounts for which it acts as a QI
- Designate those accounts for which it assumes primary NRA withholding responsibility and/or primary Form 1099 and backup withholding responsibility, and
- Provide sufficient information to allocate the payment to a withholding rate pool.

Continued on next page

Documentation

A QI is not required to forward documentation obtained from foreign account holders to the U.S. withholding agent from whom the QI receives a payment of U.S. source income.

The QI maintains such documentation at its location and provides the U.S. withholding agent with withholding rate pools.

A QI is required to provide U.S. withholding agent with information regarding U.S. persons subject to Form 1099 information reporting, unless the QI assumes the primary obligation to file the Form 1099 and backup withholding.

Withholding Rate Pools

A withholding rate pool is a payment of a single type of income that is subject to a single rate of withholding.
Treas. Reg. § 1.1441-1(e) (5) (v) (c).

Form 1042-S Reporting

A QI is permitted to report payments made to its direct foreign account holders on a pooled basis rather than reporting payments to each direct account holder specifically.

Collective Refund Procedures

A QI may seek a refund on behalf of its direct account holders. The direct account holders, therefore, are not required to file returns with the IRS to obtain refunds, but rather may obtain them from the QI.

Nonqualified Intermediary

A nonqualified intermediary (NQI) is any intermediary that is a foreign person and that is not a qualified intermediary.
Treas. Reg. § 1.1441-1(c) (14).

Continued on next page

Withholding Statement

A withholding statement for a NQI must contain the following information:

- Name, address, and TIN of each person for whom documentation is provided.
- The type of documentation (W-8 or W-9) for each person documentation is provided.
- The type of recipient is, based on codes used on Form 1042-S.
- Information allocating each payment, by income type to each payee.
- The rate of withholding that applies to each foreign person to whom a payment is allocated.
- A foreign payee's country of residence.
- If a reduced rate of withholding is claimed, the basis for a reduced rate of withholding.
- In the case of treaty benefits claimed by entities, whether the application limitation on benefits statements and the statement that the foreign person derives the income, for which treaty benefits are claimed, have been made.
- The name, addresses, and TIN of any other NQI, flow-through entity, or U.S. branch from which the payee will directly receive a payment.
- Any other information a withholding agent requires to fulfill its reporting and withholding obligations.

Areas Changed – Withholding at Source

Areas of the Withholding Regulations Changed after December 31, 2000

The IRS proposed new withholding regulations in April 1996, then modified them and made them final in November 1997 in Treasury Decision 8734, 1997-44 IRB 5. This comprehensive revision is designed to coordinate wage withholding, backup withholding, and withholding at source. It contains many changes in withholding at source procedures. Six appear to be most important. The proposed regulations:

- Eliminate the address system under which recipients of dividends are presumed to be residents of the country of their mailing address and requires them to apply for treaty benefits
- Consolidates Forms W-8, 1001, and 4224 into a new Form W-8 series
- Contain rules for determining who a beneficial owner of income is
- Include presumptions to guide withholding agents in the absence of adequate information and to coordinate domestic backup withholding and information reporting
- Authorize use of documentary evidence instead of Form W-8 for offshore accounts, and
- Create a system of Qualified Intermediaries, foreign financial institutions that assume certain withholding and reporting responsibilities under agreements with the IRS.

Continued on next page

Forms in use Prior to December 31, 2000

Payees may apply for an exemption from withholding by filing one of these forms with the withholding agent:

- Form 1001, Ownership, Exemptions, or Reduced Rate Certificate, used to claim treaty benefits.
- Form 1078, Certificate of Alien Claiming Residence in the United States.
- Form 4224, Exemption from Withholding of Tax on Income Effectively Connected with the Conduct of a Trade or Business in the United States.
- Form 8233, Exemption from Withholding on Compensation for Independent Personal Services of Nonresident Alien Individual, or
- Form W-8, Certificate of Foreign Status, used to establish foreign status for purposes of the portfolio interest exception and for purposes of exemption from domestic backup withholding and information reporting.

Withholding Rates

Rate

IRC §§ 871 and 881 specify a tax rate of 30 percent of gross income.

Treaty rates

Tax treaties commonly reduce the rates for withholding at source, usually to the same rate for both countries on the same kind of income. Because each treaty is individually negotiated, the U.S. treaties with other nations adopt different rates and apply them to different kinds of income.

IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, lists all the treaty rates currently in effect and include extensive instructions. The details of each tax treaty are so different, and the rate tables are so heavily footnoted, take care to read all footnotes for the country and types of income in question.

Application

Payees may apply for a reduced rate under a treaty by filing the appropriate Form W-8 with the withholding agent. The withholding agent should keep Form W-8s on file.

Examination Techniques

Form 1042 Examination

An examination of the withholding tax due is an examination of Form 1042 separate from the examination of a taxpayer's Forms 1040, 1120, or other return. If no Form 1042 was filed, you may have to use substitute for return procedures. At the conclusion of the Form 1042 examination, you must write a separate International Examiner's Report.

Planning

When you plan a Form 1042 examination, consider including the following steps:

- Review Forms 5471, 5472.
- Request copies of all Forms 1001, 1042, 1042-S, 1078, 1099, 4224, 8233, and W-8.
- Check that filing was timely.
- Reconcile the amounts on all Forms 1042-S with Form 1042.
- Reconcile the withholding rates used to treaty rates and for years after December 31, 2000, Forms W-8 (all four) and Forms W-9. For years prior to January 1, 2001, Forms 1001, 1078, 4224, and 8233 W-8.
- Review Forms 1099 for possible nonresident aliens (those with:
- Foreign addresses
- No addresses
- Addresses in care of someone, or
- No Social Security numbers).

Continued on next page

Planning (continued)

- Reconcile amounts on Forms 1042-S to the taxpayer’s books and records.
- Review the procedures the withholding agent used to determine residence and application of withholding at source.
- Review the appropriate accounts in the books and records to ensure that withholding was considered for all U.S. source fixed or determinable annual or periodical income paid to foreign persons or entities.
- For payments made by independent withholding agents, review the information given to the withholding agent for adequacy and completeness.

(These steps are not meant to be all-inclusive; the International Examiner should customize his/her audit procedures to fit each audit situation).

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Exercises

Exercise 1

Which of these is fixed or determinable annual or periodical income (FDAP)?

a. Salesman's commissions
b. Property insurance premiums paid by a tenant on behalf of the landlord
c. Alimony
d. Tax refunds
e. Prizes
f. Income from discharge of indebtedness
g. Insurance proceeds from loss of goods in transit
h. Winning purses from horse races
i. Premiums for insurance of U.S. risks
j. Lecture fees
k. Government agricultural subsidies
l. Cash surrender value of an insurance policy
m. Capital gain dividends of a regulated investment company
n. Patronage dividends paid by a cooperative
o. Income from hedging transactions.

Answer: a, c, e, h, j, l, n

Continued on next page

Exercise 2

Chilton Corp., a large, publicly held corporation, has stockholders in many countries. It hires a large New York bank to be its disbursing agent for its dividends. Which is the withholding agent, the corporation or the bank?

Answer: Bank

Exercise 3

Mr. Autauga, a native of Mexico, has graduated from law school and established a practice in El Paso, Texas. To help him get started, his parents bought an office building in El Paso and rented space to him for $500 per month. He sends them a check monthly. How much should his checks be?

Answer: Assuming parents are residents of Mexico
500 less 30% unless a treaty rate is lower.

Continued on next page

Exercise 4

You are examining the returns of Baldwin Oil Company, which produces oil from many properties in Oklahoma, among them the Barbour farm. Mrs. Barbour is a pioneer Oklahoman and the elderly widow of a prominent farmer. She still owns the farm, which her son now operates. On May 15 of last year she moved to the Bahamas. Baldwin Oil Company has been producing oil from the Barbour farm for many years and paying royalties to her 10 days after the end of each calendar quarter. In recent years, her royalties have been steady at $3,000 per quarter. How much should Baldwin Oil Company have withheld from her royalties last year?

Answer: zero, US citizen

Exercise 5

Bullock Ltd. is a multinational conglomerate based in Toronto. Bullock USA, a wholly owned subsidiary, conducts all its operations in the United States. During the year you are examining, Bullock USA paid dividends of $8,000,000 to the parent company. How much should have been withheld?

Answer: $2,400,000 unless there is a lower treaty rate.

Continued on next page

Exercise 6

You are examining the returns of the Bank of Bibb. Among its activities is paying pensions from various pension funds for which it is trustee. You review those payments and find that the bank did not withhold any tax from pension payments to former Professor of Classics Blount. Professor Blount is a Greek citizen who taught at Calhoun State University for many years then retired to a small Greek island. You have checked IDRS and found that Professor Blount has not filed any U.S. income tax returns since he retired 6 years ago. You also have checked with the Immigration and Naturalization Service and found that Professor Blount notified them of his intent to abandon his status as a permanent U.S. resident shortly after he retired. Should the bank have withheld anything, and if so what percentage?

Answer:

No – if presumed US person with valid TIN and address in treaty country

Yes – if presumed not US person

Regulation 1.1441-1(b)(3)(iii)(C)

Exercise 7

Conecuh S.A. is a mining company incorporated in Chile. All its shareholders live in Chile. Conecuh has a U.S. branch that operates mines in Arizona, Nevada, and Montana. For the last several years, the gross income of these mines was 40 percent of the whole company's gross income. Under IRC § 861(a)(2), 40 percent of its dividends are thus U.S. source. During the year you are examining, Conecuh paid dividends of $20,000,000 to its shareholders. It withheld no U.S. tax on these dividends. Should it have, and if so how much?

Answer: 20,000,000 x 40% x 30% = 2,400,000

Continued on next page

Exercise 8

Cleburne Ltd., an Australian company, operates a branch in Los Angeles.

a. The Los Angeles branch invests its idle working capital in short-term investments with its Los Angeles bank. What rate of tax should the bank withhold on interest it pays to Cleburne and why?
b. The Los Angeles branch also makes periodic payments on U.S. dollar loans it took out from a large Japanese bank specifically to pay for beginning operations in Los Angeles. What rate of tax should it withhold on these payments and why?

Answer:

a. 0 bank interest per IRC 871
b. 30% non US person

Exercise 9

Colbert Corp. is a Delaware corporation that does all of its business in Latin America. In the year you are examining, it paid interest expense of $1,000,000 to its parent company in Ireland. Colbert met the foreign business test of IRC § 861(c). What amount should Colbert have withheld from the interest payment to its parent?

Answer: 0

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Exercise 10

Butler Inc. is a U.S. corporation wholly owned by a Dutch corporation, which is in turn wholly owned by five Dutch brothers and sisters. It is well into the 34 percent tax bracket. It paid $2,000,000 in interest to each of the brothers and sisters during the year you are examining. You have raised a debt versus equity issue. You also have raised a sham corporation issue on Butler, Inc.'s parent company.

a. What is the tax effect of the debt versus equity issue?
b. What is the additional tax effect of the sham corporation issue?

Answer:

a. converts interest expense to non deductible dividends
b. dividends are subject to withholding

Exercise 11

Choctaw Trust, a U.S. charitable trust, has one beneficiary, Clarke Trust, a Bermuda trust. Choctaw Trust owns a medical corporation that operates the practice of Dr. Clay in Florida. During the year you are examining, the medical corporation paid Choctaw a consulting fee of $400,000, and Choctaw distributed the same amount to its beneficiary, Clarke Trust. Is any withholding at source required? If so, how much and by whom?

Answer: yes, 400,000 x 30% = 120,000
Choctaw

Continued on next page

Exercise 12

Coffee, Inc., incorporated in Delaware, is a wholly owned subsidiary of Coffee S.A. of Buenos Aires, Argentina. It imports Coffee S.A.'s products into the United States, markets them, and handles all Coffee business in the United States. You are examining the returns of Coffee, Inc. and discover that Coffee, Inc. has several large notes payable to Coffee S.A. and frequently advances funds to Coffee S.A. on an open account receivable, the balance of which has been increasing. The interest due on the notes payable for the year according to their terms was $640,000, and the interest income earned on the account receivable from Coffee S.A. according to the terms of that agreement was $440,000. You find a journal entry at yearend crediting the account receivable for $200,000 with the explanation, "Net interest due S.A." When you ask the tax manager how much tax Coffee, Inc. withheld on the interest, the tax manager tells you none because it was not paid during that year. Should you propose an adjustment to withholding tax, and if so how much?

Answer: yes 200,000 x 30% = 60,000

Exercise 13

Coosa is a Belgian plastics manufacturer. To expand into the United States, it incorporated Coosa USA, Inc. and capitalized it with $100 million. Three months later Coosa deposited $500 million in an interest-bearing account with Covington Bank in London as an investment. Another seven months later Coosa USA applied for and received a loan of $460 million from Covington Bank to buy assets in the United States. Correspondence from Covington Bank indicated that the interest rate on the loan was one percent below prime rate rather than prime because the loan was secured. Coosa USA executed no security agreements on the assets it purchased. When Coosa USA paid interest to Covington Bank, it did not deduct any withholding tax. Should it have, and if so what percentage?

Answer: yes 30% Regulation 1.1441-3(g)(1)

Continued on next page

Exercise 14

You are examining Chambers (US), a wholly owned subsidiary of Chambers Ltd., a manufacturer incorporated in Taiwan. Chambers (US) is responsible for distributing Chambers Ltd.'s products in the US and all other business of Chambers Ltd. in the US. Chambers (US) was incorporated more than 15 years ago and has lost money every year. You find that Chambers (US) is usually short of cash and is perpetually tardy in paying Chambers Ltd. for the goods it imports. During the years you are examining, Chambers (US)'s accounts payable to Chambers Ltd. averaged 247 and 273 days old, respectively. You have computed the potential §482 interest adjustment to be $4.2 million in your first year and $4.5 million in your second year. Should you propose the adjustment, and if so why?

Answer: yes profits are being diverted Outside US

Exercise 15

Which of the following are characteristics of a QI?

a. A foreign financial institution;
b. Withholding agreement with the IRS;
c. Simplified reporting rules;
d. Withholding rate pools;
e. Required to forward documentation for NRA account holders to U.S. withholding agent;
f. Reports on Form 1042-S for each NRA account holder;
g. May seek refunds on behalf of NRA account holders.

Answer: a, b, d, f, g

International Technical Training

Chapter 12A

Formal Document Request

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 1.5 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk • Access to IRWeb
Participant References	• None
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by instructor) • Flipcharts and markers

Overview

Introduction

Getting all the information needed is one of the consistent challenges of the revenue agent's job. For you as an international revenue agent, this may present an even greater problem because you sometimes need information which is outside the United States, and thus may be beyond the reach of the Internal Revenue Service (Service).

Taxpayers sometimes refuse to furnish foreign information, claiming the IRS has no right to records outside the United States. More often, they may claim the records do not exist, cannot be obtained, or cannot legally be provided.

Foreign law, foreign languages, foreign business practices, foreign recordkeeping practices, jurisdictional questions, and distance all contribute to the difficulties that you may have getting information.

This module will inform you about some of the methods of obtaining information unique to foreign records.

Contents

This lesson covers the following topics:

Continued on next page

Introduction

Formal document requests (FDRs) force the taxpayer to choose between giving foreign records to you or not using them later in court.

References

- IRC § 982
- IRM 4233, “Tax Audit Guidelines, Individuals, Partnerships, Estates and Trusts, and Corporations”. Exhibit 500-10.

Objectives

At the end of this lesson you will:

- Be able to identify when to use a formal document request (FDR), and
- Know the procedures relative to the use of an FDR.

Instructor Notes

Please review lightly summons and emphasize the differences between summons and FDR.

Relationship to Other Topics

This lesson relates to all the other lessons in International Issues training because problems obtaining foreign records are common to all international issues

Background

To properly examine most international issues, you must use aggressive yet reasonable audit techniques to gather the information needed. Only when you have all the facts can you determine whether or not the taxpayer complied with all the relevant provisions of the law.

Prior to the enactment of IRC § 982, taxpayers could:

- Keep records offshore,
- Not provide records during an examination, or
- Provide only a part of the records either during the examination or during litigation.

Use of Formal Document Request

Instructor Notes

Please review the procedures and IRM 4.2.3.3 Exhibit 500-10 with the class.

Reading Assignment

IRC §§ 982(a) - General rule and 982(c) (1).

General Rule

A taxpayer cannot be forced to produce foreign records. It only prohibits courts from allowing the introduction of records not produced. IRC § 982(a) is a shield, not a sword.

Prerequisites

Before issuing an FDR, there are two requirements that must be satisfied:

- The normal request procedures must have been used, and
- The taxpayer must have failed to produce the documents.

Exhibit 500-10 in IRM 4233 instructs you to use Form 4564, “Information Document Request”. to document the normal Information Document Request (IDR). *An IDR must be issued before an FDR can be issued*.

Procedures

The FDR :

- Can be “any request”,
- Can be mailed by registered or certified mail, and
- Will be sent to the taxpayer at the last known address.
- Applies to books and records located “outside the United States”.

As a consequence of the first procedure, a special form has been not been created. IRM 4233, Exhibit 500-10 instructs you to use Form 4564 and a cover letter and includes a pattern for the cover letter.

Continued on next page

Procedures (continued)

Because the FDR will be sent to the taxpayer's last known address, you must be sure you mail the FDR to the latest address the taxpayer has given the Service, not the address on the tax return.

Review

Exhibit 500-10 in IRM 4233 also requires that all FDRs, at a minimum, must be reviewed by District Counsel before issuance. Local district procedures may require other reviews as well. If you anticipate issuing an FDR, you should contact District Counsel so advice can be rendered relative to the wording on the IDR prior to the issuance of the FDR.

Contents

The FDR must be mailed by registered or certified mail to the taxpayer's las known address, and must set forth:

1. The time and place for the production of the documentation;
2. A statement of the reason the previous production (if any) was insufficient;
3. A description of the documents requested, and
4. The consequences to the taxpayer if he fails to produce the described documents.

For the *first requirement*, remember that IRC § 982(a) specifies the date be the 89th day after mailing. The place usually should be the taxpayer's place of business or where the examination is being conducted. Both the time and location must be reasonable.

For the *second requirement*, it is helpful to attach a copy of the previous request (original IDR) to make the statement clear.

For the *third requirement*, you must be sure the FDR does not request more records than the IDR issued previously. If additional records are necessary, an additional (second) IDR must be issued, to be followed by a second FDR, if necessary. As with any request for foreign records, you may require:

- Original records be provided, and
- Translations into the English language be furnished.

Continued on next page

Contents (continued)

For the *fourth requirement*, state that the Government will invoke IRC § 982(a) in any future litigation on these tax issues.

Reading Assignment

IRC § 982(d).

Definitions

Please note that this section only applies to:

- books and records
- located “outside the United States”.

Thus, you may not issue an FDR to interview someone. However, “books and records” are to be interpreted broadly, extending to any and all accounting records and company data, according to the Conference Committee Report.[1]

Thus, you may not issue an FDR to interview someone. However, “books and records” are to be interpreted broadly, extending to any an all accounting records and company data. These records only need to be either “relevant” or “material”. Either justification will do, or both are broad terms.

“Books and records” also includes documents held by a foreign entity whether or not controlled by the taxpayer, according to the Conference Committee Report.[2]

Continued on next page

[1] Conference Report No. 760, 97th Cong., 2d Sess., 591, 592 (1982), 1982-2 C.B. 658.
[2] Ibid.

Use with Summons

Because an FDR is only a shield, you may choose to use both a sword and a shield at the same time. In that case, you would issue an FDR and a summons simultaneously for the same records. This is especially advisable if:

- The location of the documents is not certain, or
- You suspect the taxpayer may move documents into the United States to avoid complying with an FDR or out of the United States to avoid a summons.

Follow the separate procedures for each procedure and issue both the FDR and summons on the same date.

Dealing with Problems Responses

Instructor Notes

Please review with the class all the reasonable cause in the IRM starting with 20.1.1.3.2 which is based on all the facts and circumstances in each situation.

Reading Assignment

IRC §§ 982(b) (1), and 982(b) (2).

Reasonable Cause

IRC § 982(b) (1) provides that the sanction of inadmissibility does not apply if the taxpayer establishes that failure to provide documents is due to reasonable cause. IRC § 982(b) (2) adds that disclosure penalties under foreign law are not reasonable cause.

The Conference Committee Report mentions four causes for not providing documents which are reasonable:

- The request is unreasonably broad,
- The documents or copies thereof are available within the United States (and thus subject to summons),
- The place of production is unreasonable, and
- Status as a minority owner, depending on the facts and circumstances.

The report also says reasonable cause may excuse a delay in providing records, such as time required to have records translated into English.

Continued on next page

Reading Assignment

IRM 4233: Exhibit 500-10.

Substantial Compliance

Once a formal document request has been issued to the taxpayer, the taxpayer has 90 days to comply. If the taxpayer fails to *substantially* comply with the FDR, then any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall prohibit the taxpayer from introducing any foreign-based documentation covered by the request.

If a Court Determines	***Then***
compliance has not been substantial,	none of the records requested are admissible, not even those provided to the Service.
compliance has been substantial,	all requested records are admissible, even those not provided to the Service.

Copies of Records

IRM 4233: Exhibit 500-10 provides that true copies may be acceptable if the foreign country makes it impossible to remove the documents from the country for reasons other than secrecy laws.

Extension of 90 Day Period

The taxpayer may request an extension of the 90-day time limit to respond. Either the Service or a court with jurisdiction over a taxpayer's petition to quash a formal document request may grant an extension.

Petition to Quash

Instructor Notes

Please emphasize the following points:

1. Petition to quash,
2. Suspension of the statute of limitation,
3. Counsel's notification at receipt of petition to quash.

Petition to Quash

A taxpayer may attempt to quash an FDR within 90 days of mailing of the FDR. The motion to quash is accomplished by the taxpayer filing a petition in court. Once in court on the taxpayer's petition to quash, the Service may seek to compel compliance with the request and a court can order the taxpayer to comply.

Statute Suspended

While court action on a petition to quash is pending, the 90-day period for compliance is suspended. The statute of limitations also is suspended while court action and any appeals on a petition to quash are pending.

Action of the International RA

If you learn that the taxpayer has filed a petition to quash an FDR, IRM 4233, Exhibit 500-10 instructs you to:

- Notify the Office of District Counsel by telephone the same day,
- Send a written recommendation for defense of the petition to the Office of District Counsel within six working days, and
- Include in the recommendation whether the Service should seek to compel compliance with the formal document.

Summary

1. A formal document request (FDR) is used to obtain foreign-based records when a taxpayer has failed to produce all of the foreign records requested in Information Document Requests (IDRs).
2. An FDR cannot force a taxpayer to produce foreign records, but will prohibit the taxpayer from introducing any foreign-based records covered by the FDR.
3. IRC § 982(d) only applies to:
   - Boos and records
   - Located “outside the United States”.

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International Technical Training

Chapter 12B

Summons

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • PowerPoint Notes • CCH Disk
Participant References	• None
Equipment and Supplies	• Computer projection system and screen • Flipcharts and markers

Overview

Introduction

Taxpayers usually provide information requested during an examination and make themselves or other key people available for an interview. However, there may be situations where the taxpayer refuses to cooperate. When you determine that information or testimony may be relevant to the development of an issue and the taxpayer is unwilling or unable to provide the facts, a summons may be the appropriate tool to obtain the information and documents you need to effectively examine a return and determine if a return is in compliance with the Internal Revenue Code.

Issuance of a summons is often the only tool you, as a revenue agent, will have to secure information from third parties who may have information and documents relevant to the examination of a return.

This lesson will introduce you to summons authority and when a summons may be the appropriate tool to obtain records and testimony.

Objectives

At the end of this lesson, you will be able to:

- Identify Code sections and IRM references relevant to a summons;
- Identify when a summons is appropriate;
- Apply third-party contact procedures;
- Prepare and serve a summons;
- Apply summons enforcement procedures;
- Identify when to issue a formal document request (FDR); and
- Identify what is a privileged communication and when a privilege is appropriate.

Continued on next page

Contents

This lesson covers the following topics:

Resources

Instructor Notes

Please have the participants peruse through the IRC code sections and the IRM sections so they will familiar with the subject. The instructor can give a few examples on his/her experience with summons. See PowerPoint slides 8, 9, and 10.

Code Sections

The provisions of the law for using and enforcing a summons are contained in the following IRC sections:

- IRC §7602 Examination of Books and Witnesses
- IRC §7603 Service of Summons
- IRC §7604 Enforcement of Summons
- IRC §7605 Time and Place of Examination
- IRC §7609 Special Procedures for Third-Party Summonses
- IRC §7610 Fees and Costs for Witnesses
- IRC §7612 Special Procedures for Summonses for Computer Software
- IRC §7622 Authority to Administer Oaths and Certify
- IRC §7210 Failure to Obey Summons
- IRC §7402 Jurisdiction of District Courts
- IRC §§6420(e)(2), 6421(g)(2) and 6427(j)(2) Claims
- IRC §6503(j) Designated and Related Summons

IRM References

- IRM 25.5.1 – Summons Authority
- IRM 25.5.2 – Preparation of Summons
- IRM 25.5.3.2 – Service of Summons
- IRM 25.5.3.4 – Time and Place of Examination (Appearance)
- IRM 25.5.4 – Examination of Books and Witnesses
- IRM 25.5.5 – Summons for Taxpayer Records and Testimony
- IRM 25.5.5.4 – Rights and Privileges of Person Summoned
- IRM 25.5.6 – Summonses on Third-party Witnesses
- IRM 25.5.10 – Enforcement of Summons
- Exhibit 25.5.1-1 – General Instructions For Preparation of a Summons

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Summons for Records or Testimony

Instructor Notes

Please provide the participants a copy of the summons Form 2039 and go over the different pages of the summons. See PowerPoint slides 12, 13, and 14.

What is a Summons?

A summons is an official order for a person to appear before an authorized IRS employee and produce any records or provide testimony relevant to the inquiry.

If the person refuses to produce documents or give testimony pursuant to a summons, the IRS can seek judicial enforcement and compel the party to provide the information sought in the summons.

Form 2039, Summons, is used to summons records and testimony.

Purpose for Issuing Summons

The examiner may have to summons records or testimony because it is relevant to the development of a case.

Authorized purposes for a summons:

- Examine a tax return,
- Prepare a return for a non-filer under IRC § 6020(b),
- Determine the tax liability of any person, transferee, or fiduciary.
- Collect a tax liability, and
- Inquire into any offense connected with the administration or enforcement of the Internal Revenue Code.

A summons is used to obtain information not otherwise available from:

- A taxpayer who is:
    - Not cooperative
    - Not in possession of records
    - Unable to obtain or locate records
    - Third parties

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Purpose for Issuing Summons (continued)

Summonses are used to:
- Obtain relevant facts and background from the taxpayer ,
- Obtain a taxpayer's explanations of a transaction,
- Discover the existence and location of records and/or other parties with knowledge of the facts and circumstances, and
- Establish a record of the taxpayer's and other witnesses' positions.

Read

IRC § 7602(a).

Authority to Issue Summons

IRC § 7602(a) grants the Service the authority to examine any books, papers, records, or other data and to take testimony under oath. It also gives the Service the right to summon the person liable for the tax, any officer or employee of the person liable for the tax, or any person having possession, custody, or care of books containing entries related to the entity liable for the tax, or any other person the Secretary may deem proper.

Who may be summoned?
- Any taxpayer,
- Any employee or officer of the taxpayer, and
- Any other person having:
  - Custody,
  - Possession, or
  - Care of books and records relating to the taxpayer.

Taxpayer records may be summoned whether they are in the possession of the taxpayer or in the possession of a third-party. Records that can be summoned include:

- Taxpayer's books and records,
- Third-party books and records, and
- Other documentary evidence.

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Authority to Issue Summons (continued)

Since the summons is a legal document which, if necessary, is enforced in U.S. district court, the utmost care should be taken in preparing, and serving a summons. In addition, since the examiner must follow various administrative steps when issuing a summons, the examiner should keep in mind that while the use of a summons is encouraged, examiners should first try to secure the information voluntarily, and if appropriate, utilize the third party contact procedures.

Instructor Notes

Please emphasize the landmark case for summons *Powell v. United States, 379 U.S. 48 (1964)*.

Basic Summons Standards

Powell v. United States, 379 U.S. 48 (1964) is the leading case on summonses Under Powell, a summons is not enforceable **unless** the following requirements (known as the Powell test) are met:

1. He must show that the investigation will be conducted pursuant to a legitimate purpose,
2. That the inquiry may be relevant to the purpose,
3. That the [379 U.S. 48, 58] information sought is not already within the Commissioner's possession, and
4. That the administrative steps required by the Code have been followed,

Legitimate Purpose

A summons is enforced if a court concludes that it was issued in good faith, i.e., in furtherance of a legitimate purpose as provided in IRC § 7602(a) and (b). IRC § 7602(b) provides that an IRS summons may be issued for the purpose of "…inquiring into any offense connected with the administration or enforcement of the internal revenue laws". This has been interpreted as allowing the issuance of a summons as part of a criminal tax investigation prior to a Justice Department referral.

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Legitimate Purpose (continued)

A summons may also be issued for a dual purpose. In some instances the Service issues summonses seeking both information regarding the tax liability of a named taxpayer and information about other unidentified taxpayers.

Legitimate Purpose (continued)

Dual purpose summonses have been challenged on the grounds that the IRS failed to comply with the provisions of IRC § 7609(f) for issuing a “John Doe” summons. However, the Supreme Court has held "that where, pursuant to IRC § 7602, the IRS serves a summons on a known taxpayer with the dual purpose of investigating both the tax liability of that taxpayer and the tax liabilities of unnamed parties, it need not comply with the requirements for John Doe summonses set out in IRC § 7609(f), as long as all the information is relevant to a legitimate investigation of the summoned taxpayer”. Tiffany Fine Arts, Inc v. United States, 469 U.S. 310, 316-17 (1985).

Instructor Notes

Please see PowerPoint slides 15 and 16.

Relevance

IRC § 7602(a) (1) states that the Service is authorized to examine any documents which “**may be** relevant or material to such inquiry”.

For that reason:

1. Information requested must shed light on the taxpayer’s correct tax liability,
2. Although the standard is very lenient, no fishing expeditions are allowed, and
3. The Service can request information outside the examination years so long as it facilitates the determination of the correct tax liability of the years under examination.

Often when a summons is attacked for relevancy, the argument is also made that the summons request is overbroad and/or unduly burdensome and constitutes an unreasonable search in violation of the Fourth Amendment.

Continued on next page

Relevance (continued)

All that is required is for the summons to describe the documents with sufficient particularity and not be excessive for purposes of the inquiry. If the summons seeks information relevant to the Service's inquiry, it is not unduly burdensome merely because it requires production of or review of a great many records or will result in significant expenditure of the record-keepers' time and money.

Relevance – U.S. v. Davey

In U.S. v. Davey, 543 F.2d 996 (1976), the court, on appeal, determined that the' summons validly required the taxpayer to produce an original computer tape because IRC § 7602 allows the IRS access to all relevant or material records and data in the taxpayer's possession. The taxpayer's records of expenses and losses were transferred from original vouchers, invoices and other source documents onto punched computer cards, which were then used to produce magnetic tapes in order to facilitate IRS audits. The IRS issued a summons to compel the taxpayer to produce the tapes. The lower court modified the summons and required the taxpayer to produce duplicate rather than original computer tapes, and also required the IRS to bear the costs of duplication.

The taxpayer argued the summons was abusive and the taxpayer's need to protect the tapes from loss or damage warranted the IRS to bear the cost of duplicating the tapes. On appeal, the court held that the taxpayer failed to meet its burden of showing how the summons was abusive after the IRS made a minimal showing of **relevancy**, and held that the IRS was entitled to the original tapes, with no strings attached or conditions imposed. The taxpayer's gold to protect the tapes from loss or damage did not warrant the IRS to bear the cost of duplication.

Once the IRS makes a minimal showing of relevancy regarding a request for records, the burden shifts to the taxpayer to show why the summons might represent an abuse of the summons process and should not be enforced.

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Possession by the IRS

To satisfy the third Powell requirement, the IRS must show that the summoned information is not already in the Service's possession. A simple statement in the IRS agent's declaration that the summoned information is not in the possession of the IRS is sufficient to shift the burden of proof to the party opposing enforcement to come forward with evidence to the contrary. To carry its burden, the party opposing enforcement must show not only that the IRS possesses the information, but also that the IRS can readily retrieve the information.

The courts have held that the IRS can summon documents that may be in its possession but which are difficult to retrieve, may demand production of original documents rather than copies, or may demand production of retained copies of tax returns to compare with the originals filed with the IRS.

Instructor Notes

Please see PowerPoint slide 18.

Administrative Steps Required by the Internal Revenue Code

The fourth element of the Powell requirement is that the IRS must comply with the administrative steps required by the Internal Revenue Code.

These administrative steps generally revolve around service of the summons. Challenges to a summons based on procedural defects or an agent's failure to follow directives found in the Internal Revenue Manual are generally rejected by the courts.

In most cases, when the IRS learns of a procedural defect in a summons, it will simply issue a new summons. However, even where the defect cannot be so easily cured, courts have applied a "no harm, no foul" approach to reviewing summonses for procedural or administrative deficiencies.

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Administrative Steps Required by the Internal Revenue Code (continued)

Thus, merely showing that an administrative step required by the Code has not been followed will not automatically defeat enforcement. Rather, the court will "evaluate the seriousness of the violation under all the circumstances including the government's good faith and the degree of harm imposed" by the violation. Notwithstanding the aforementioned, agents must insure that the summons is properly served to save the time and resources of the Service Department of justice, and the courts.

Who Can Issue a Summons?

A summons can be issued by:

- Internal Revenue Agent,
- Estate Tax Attorneys,
- Estate Tax Examiners,
- Revenue Service and Assistant Revenue Service Representatives,
- Tax Auditors,
- Tax compliance Officers,
- Revenue Officers, GS-9 and above,
- Tax Law Specialists, and
- Compliance Officers.

Timing of Summonses

Consider serving a summons in the following situations:

- No records are made available to permit an adequate examination within a reasonable period of time.
- Submitted records are known or suspected to be incomplete.
- Additional records are presumed to be in the possession of the taxpayer or a third party that may disclose material matters not reflected in the submitted records (i.e. broker statements, contracts, and bills for legal expenses).
- Taxpayers or taxpayers' representatives will not seriously attempt to provide documentation for substantiation to the examiner because they intend to offer records and explanations at another level or after a notice of deficiency has been issued.
- The existence and location of records are in doubt.

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Issuance of Information Document Requests before Summons

As part of our efforts to obtain information voluntarily from taxpayers, we issue Information Document Requests or "IDRs" (Form 4564). IRM 4.10.2.9.3. Properly drafted, IDRs can form the basis for a summons, but do not use the IDR as an attachment with a summons. The IDRs must specifically identify the books, papers and other data being sought, and should utilize descriptive titles, dates and page references, where applicable.

The administrative summons provides a mechanism for obtaining information not provided voluntarily. Although you are not required that you issue an IDR before you issue a summons, you should attempt to obtain information voluntarily from taxpayers and witnesses prior to issuing a summons.

Many third parties, including financial institutions are subject to the Right to Financial Privacy laws and the Bank Secrecy Act (Title 31 USC) will not provide documents without a summons.

Third-Party Contacts

Instructor Notes

Please emphasize third-party contacts and Form 12175 and see PowerPoint slides 21, 22, and 23.

Read

IRC § 7602(c).

Advance Notice Requirements

Summonses served on third parties are considered third party contacts under RRA 1998, section 3417. Accordingly, prior to serving a third-party summons, the taxpayer must be provided notification that the Service may contact third parties. Notification is accomplished by providing the taxpayer one of the letters in the Letter 3164 series, or by providing the taxpayer with Publication 1 which contains a section on Third Party Contacts.

The Secretary shall periodically provide to a taxpayer a record of persons contacted during such period by the Secretary with respect to the determination or collection of the tax liability of such taxpayer. Such record shall also be provided upon request of the taxpayer.

Form 12175, *Third Party Contact Report Form*, must be completed when a third party contact is made. The form is completed for third party contacts whether or not the third party is subject to the notice requirements. The completed form is forwarded to the designated Third Party Contact Coordinator after a contact is made.

There are certain exceptions in which the taxpayer need not be notified of a third party contact.

- To any contact which the taxpayer has authorized,
- If the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person, or
- With respect to any pending criminal investigation.

Continued on next page

Advance Notice Requirements (continued)

If a fear of reprisal has been indicated, the examiner should check the "Reprisal" box on the Form 12175 and only complete the following data on the Form 12175:

- Taxpayer TIN,
- Name control,
- Employee ID number,
- Telephone number,
- Mail Stop number,
- Date of contact, and
- Category code

Types of Summonses

Instructor Notes

Please spend time on this section. See PowerPoint slides 24, 25, 26, 27, and 28.

Read

IRC § 7609.

Third-Party Summons

IRC § 7609 provides the special procedures that need to be followed for all third-party summonses. Keep in mind that the term “third-party summons” does not have the same meaning as the term “third-party record-keeper summons”. While all third-party record-keeper summonses are third-party summonses, not all third-party summonses are third-party record-keeper summonses. There are two types of third-party summonses:

- Third-party record-keeper, and
- All other third-parties with information relevant to the examination.

A third-party record-keeper is defined by IRC § 7603 to include the following:

- Banks;
- Consumer Reporting Agencies;
- Credit Card Companies;
- Securities Brokers;
- Attorneys;
- Accountants;
- Enrolled Agents;
- Barter Exchanges;
- Regulated Investment Companies; and
- Any owner or developer of a computer source code.

Continued on next page

Third-Party Summons (continued)

A third-party summons does NOT include the following:

- Summons served on the taxpayer or officer or employee of the taxpayer;
- Summons issued to aid in collection of tax;
- Summons issued by Criminal Investigation;
- "John Doe" summons;
- Summons issued only to determine whether or not records have been made or kept; and
- Summons issued to determine the identity of certain bank account holders.

Preliminary Summons

A preliminary summons is issued solely to determine whether a witness has records pertaining to a taxpayer or other entity in which you are interested. A preliminary summons does not require you to give notice of the summons under IRC § 7609.

A "preliminary summons" that is exempt from the notice requirements of IRC § 7609 should include the following language on the summons form where you would normally type the description of records:

Continued on next page

Preliminary Summons (continued)

For a bank:

This summons is issued in accordance with Internal Revenue Code section 7609(c) (2) (B), solely to determine whether or not records of the business transactions or affairs of the above-identified taxpayer [or other related person in whom you are interested] have been made or kept. You are not required to produce any records in response to this summons. Please search your records, including records of any private banking department, for records of any accounts, including checking accounts, savings or depository accounts of any kind, safe deposit boxes, loan accounts, credit card accounts, and brokerage accounts, under any name, over which [name of taxpayer or other related person in whom you may be interested] had signature or other authority, whether exercised through powers of attorney, letters of direction, or any device whatsoever, during the year(s) ________________ , and provide us with an affirmative or negative response as to whether you have such records. If the response is affirmative, provide us with a brief description of the type of records you have relating to the credit card account.

You may comply with this summons by mail addressed to:

[address]

Continued on next page

Instructor Notes

Please give the participants real life example on UBS Swiss Bank John Doe summons on Voluntary Disclosure Program (VDP) cases. Please see PowerPoint slide 30.

Preliminary Summons (continued)

<u>For a third-party processor:</u>

> This summons is issued in accordance with Internal Revenue Code section 7609(c)(2)(B), solely to determine whether or not records of the business transactions or affairs of the above-identified taxpayer involving MasterCard number 1234-5678-9012-3456 have been made or kept. You are not required to produce any records in response to this summons. Please search your records, including records maintained by you on behalf of third-party card issuers, and provide us with an affirmative or negative response as to whether you have such records. If the response is affirmative, provide us with a brief description of the type of records you have relating to the credit card account.
>
> You may comply with this summons by mail addressed to:
>
> [address]

If there is not enough space on the summons form to type this language, then type the language on an attachment.

You can obtain assistance from Counsel to modify this language for another type of witness.

Continued on next page

John Doe Summons

Under IRC § 7609(f), a John Doe summons is one "which does not identify the person with respect to whose liability the summons is issued”. The John Doe summons procedure applies to situations where the IRS does not know the identity of the taxpayer under investigation. See Tiffany Fine Arts, Inc v. United States, 469 U.S. 310, 316-17 (1985).

A John Doe summons may be served only after an ex parte court proceeding in which the IRS establishes that: (1) the summons relates to the investigation of a particular person or ascertainable group or class of persons; (2) there is a reasonable basis for believing that such persons may have failed to comply with the internal revenue laws; and (3) the information sought is not readily available from other sources.

Read

IRC §§ 6501, 6501(A), 6501(J) and 6501(k).

Designated Summons

IRC § 6503(j) suspends the statute of limitations on assessment under IRC § 6501 where a designated or related summons is issued and enforced. A designated summons is a summons issued to determine the amount of any internal revenue tax of a corporation for which a return was filed if certain additional requirements are satisfied. There can be only one designated summons per tax return and it is the first one so issued. A designated summons may only be issued to a corporation (or any other person to whom such corporation has transferred records) if the corporation is being examined under the IRS’ coordinated examination program (CEP) “or any successor program”, such as the current coordinated issue case (CIC) program.

The designated summons must be issued at least 60 days before the day on which the statute of limitations on assessment under IRC § 6501 would otherwise expire. The summons must clearly state that it is a designated summons for purposes of section 6503(j).

A designated summons extends the statute of limitations for assessment. If a court proceeding is not brought to quash, or to enforce a designated or related summons, the statute of limitations is not suspended under IRC § 6503(k). If the witness complies with the designated summons, the normal statute of limitations applies.

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Related Summons

A related summons is any other summons that is issued with respect to the same tax return of the corporation as a designated summons and is issued during the 30-day period that begins on the date the designated summons is issued. While only one designated summons may be issued per tax return, any number of related summonses may be issued during the 30-day period beginning on the date that the designated summons is issued. A related summons must concern the same return for which the designated summons was issued. The IRC § 6503(k) suspension applies to a related summons whether issued to the party to whom the designated summons was issued or to another party.

IRC § 6503(j) is designed to counter taxpayers who refuse to extend the statute under IRC § 6501(a), or who terminated a voluntary period of limitations extension before the IRS has had a chance to develop its case.

Summons Preparation

Instructor Notes

Please emphasize this important session. See PowerPoint slides 33 and 34.

Form 2039

The summons is Form 2039, *Summons*. (Do not use a Form 2039 that bears a revision date earlier than 12-2001). General instructions for the preparation of the summons are found in IRM 25.5.1, Exhibit 25.5.1-1.

IRM 25.5.2 contains guidance for the preparation and service of a summons, including the statement of liability, how to describe the summoned party, and how to describe the information requested. IRM 25.5.3.2 contains guidance on serving a summons to specific parties such as to a trustee, a corporate official, or a husband and wife.

Examiners must consult Counsel with all concerns or questions about how the summonses.

Form 2039 consists of five parts.

- Original Summons (Form 2039), with the Service of Summons, Notice and Recordkeeper Certificates on the reverse side.
  - Original – Kept by IRS
  - Page 2 of the Original – Kept by IRS
- **Part A** (Form 2039-A) Summons (attested copy), with a reprint of IRC provisions on the reverse side.
  - Given to person summoned
- **Part B** (Form 2039-B) Notice to Third Party Recipient of IRS Summons, with a reprint of IRC 7609 on the reverse side.
  - Given to 3rd Party Recipient (if applicable)
- **Part C** (Form 2039-C) Summons (copy), with a reprint of pertinent IRC provisions on the reverse side.
  - Given to Noticee (if applicable)
- **Part D** (Form 2039-D) cover letter/notice explaining the right to contest the administrative summons, with a reprint of IRC§7609 on the reverse side.
  - Given to Noticee (if applicable)

Continued on next page

Drafting the Summons

Refer to IRM 25.5.1, Exhibit 25.5.1-1 – General Instructions For Preparation of a Summons, and IRM 25.5.2, Preparation of Summons.

Determine what documents you need to summon:

- Only request documents already in existence
- **Never** require a summoned party to create a document. If it doesn't exist, consider an alternative that will secure the same information.
- Request documents that have a "reasonable certainty" of existence.
  - Avoid overbroad document descriptions.
  - Make limited and specific requests.
  - Make document descriptions easy to understand.
- Requests should not be ambiguous.
- Ask for all types of financial accounts if needed, not just bank accounts.
- When requesting account statements for a particular year, ask for statements covering a 14-month period, not just a 12-month period, because all statements do not end on the last day of the month, and there may be items outstanding or in transit that are from a prior period or reflected in the statement following the cutoff period.

Example 12B – 1

For account statements for the calendar year 2007, request statements for the period "December 1, 2006 through January 31, 2008".

Do not just ask for records in the summoned party's possession. Ask for records in their possession, custody or control. This includes records that might be located outside the U.S. or in the possession of other persons or entities.

If a taxpayer utilizes a foreign branch of a U.S. bank for his or her foreign trust or other offshore entity, contact Counsel for guidance on whether a summons may be issued to the U.S. bank to produce its branch records.

Continued on next page

Drafting the Summons (continued)

Example 12B – 2

"For purposes of this summons, you are required to produce all documents described in this summons (or summons attachment), whether located in the United States **or outside the United States**, that are in your possession, custody, control, or otherwise accessible or available to you either directly or through other entities".

For certain summoned witnesses, in lieu of having the person appear in person to comply with the summons, a summons cover letter can be used to provide the summoned party with the address where they can deliver the records. Another approach would be to include a statement on the Form 2039 or on the Attachment(s) to the Form 2039 stating that personal appearance is not required if the records are produced on or before the appearance date.

Example 12B – 3

"Personal appearance is not required. The information may be mailed to the address indicated below in lieu of appearance".

Instructor Notes

Please emphasize this section. See PowerPoint slides 34 through 39.

Document Dates

Every document requested should be identified by date or time period. If no date is specified, the request could be considered "vague and overbroad"; and possibly unenforceable.

This is not necessary if, the date of all documents has been defined in the "Definition Section" of the summons attachment.

The dates used to describe the documents must be relevant to the examination.

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Identification of Taxpayer

Refer to IRM 25.5.2.2.

The “matter” of the summons is the taxpayer under examination. After “In the matter of” insert the name of the taxpayer as it appears on the return under examination.

For joint returns: “John H. Smith and Mary L. Smith” (not John H. and Mary L. Smith).

Include any other information the summonsed party would need to identify the taxpayer (e.g. a bank may need the social security number of the taxpayer).

For a corporation with an aka: “ABC Corporation, aka ABC, Inc”.

Periods of Summons

On Form 2039, identify the periods under audit, not the periods for which records are requested.

- “For calendar years 2007 and 2008” (not 200712, 200812); or
- “January 1, 2007 through December 31, 2008”; or
- Years ended December 31, 2007 and December 31, 2008.

Individual Taxpayers

If the taxpayers filed joint return but you only want to summons the husband, then the summoned party is the husband.

If the taxpayer filed a joint return and you want to summons both the husband and wife, two summonses, one to each witness are required.

When summonsing records for a delinquent return examination for married taxpayers, a separate summons should be served on each spouse. The taxpayers should not be identified as joint filers for the year(s) of the delinquency, because their filing status is not determined until the return is filed.

Only ONE witness may be summoned per summons.

Continued on next page

Corporation Taxpayers

Refer to IRM 25.5.2.3.

When you summon a corporation, the summons should be directed to the corporation.

If you need the *testimony* of a person related in some way to a corporation, summons the person in his or her corporate capacity, not the corporation (i.e., President, Treasurer).

If you want a corporation to designate the appropriate person to testify, on the "To" line, type:

- "XYZ Corporation, through any officer or employee who can identify or testify as to the documents and information requested below".

Insert the name of the person summoned and the title or official status of the person, if the purpose of the summons is to obtain testimony or records from a person in his or her capacity as trustee, receiver, custodian, or public official.

If you want to summons two officers of a corporation, two summonses are required.

Location of Summoned Party

The "At" line is the address of the person summoned.

Continued on next page

Summons Attachment

Use an "attachment" if the list of documents, along with definition and instructions, does not fit on the first page of the Form 2039.

List the summoned documents in the space between the typewritten material on the form and the line: "Do not write in this space". List if a voluminous request, on a separate page. Define terms on a separate page as well.

It is generally advisable to have two separate attachments to the summons:

- Attachment A – will be a "Definitions" attachment; and
- Attachment B – will list the documents and information you are seeking.

Define terms and identify the names of all parties or entities identified the request portion of the summons in the "Definitions" attachment.

If an "Attachment to Summons" is used should clearly specify the summons to which it relates.

Example 12B – 4

"Attachment A to Summons to (name of summoned party) in the matter of (taxpayer name)".

The front page of the Summons (in the blank space between the typewritten material and the line that states "Do not write in this space") should specifically refer to the Attachment by its exact title.

Continued on next page

Summons Attachment (continued)

Example 12B – 5

"See Attachment A to Summons to (name of summoned party) in the matter of (taxpayer name)" or

"See Attachments A and B to Summons to (name of summoned party) in the matter of (taxpayer name)".

Leave no doubt that the two documents, the Summons and the Attachment, belong together.

The Attachment should NOT be a "checklist" on which you check the documents you want and do not check the documents you do not want. (If there is any item you do not seek, then it should NOT be on the Summons at all).

The Attachment should NEVER simply be a copy of an Information Document Request ("IDR"). Summons drafting is more specific and a summons is subject to much more scrutiny than an IDR.

Be aware of problems with Attachments when a summons is issued to two or more related parties (such as husband and wife, or three corporate officers).

- Make sure the name of the correct summoned party is on the top of the Attachment.
- Check the name on the Attachment top so that the Attachment with one name is not attached to a summons with another name.

A copy of the attachment should be included with all copies of the Form 2039 for service and notice.

Continued on next page

Correspondent Banks

A correspondent bank is a domestic bank where a foreign bank has an account. The account is called a correspondent account. The domestic bank is the correspondent bank and the foreign bank (account holder) is the respondent.

Correspondent accounts play an essential role in international commerce. They facilitate the transfer of funds around the world through offsetting entries on the books of banks with correspondent relationships, including wire transfers. They also permit banks in one jurisdiction to clear checks written on banks in another jurisdiction, by transmitting the checks to a correspondent bank in the jurisdiction on which the checks are drawn for credit to the correspondent account.

How Transactions are Processed

A commercial bank in the Cayman Islands may receive large numbers of checks drawn on U.S. banks from local Cayman businesses (restaurants, dive shops, etc.) who receive the checks as payment from U.S. tourists and deposit them in the businesses' accounts. In order to collect on these checks, the Cayman bank will bundle the checks with a deposit ticket and send them to its U.S. correspondent for deposit into the correspondent account. The proceeds of these checks, when collected by the U.S. correspondent become available to the Cayman respondent bank, which can wire the funds to it, its account holders, or can use the funds to cover checks it writes on the correspondent account to or on behalf of its own account holders. Trillions of dollars move through these accounts daily, predominantly in legitimate transactions.

Correspondent accounts, and the wire services that are provided to the respondent banks, may facilitate offshore tax evasion by enabling transfers into and out of the United States by U.S. customers of offshore banks. Records of such transactions can help the agent document a relationship between a U.S. taxpayer and the foreign bank or to develop evidence undisclosed transactions with foreign accounts or entities. Therefore, if an agent can identify the U.S. bank where a taxpayer's offshore bank has a correspondent relationship <u>and has evidence that the taxpayer used this account</u>; it is possible to summon the U.S. correspondent bank for records of the correspondent account.

Continued on next page

An agent summoning records of a correspondent account can expect to obtain the normal kinds of bank account records – bank statements, records of wire transactions in and out of the account, deposited items, and cancelled checks drawn on the account. The primary difference between correspondent account records and records of an individual or business account is that the account holder is another bank. The records in the account will document financial activity of many respondent customers.

For reasons described above, a correspondent account, particularly one of a busy commercial bank in an offshore jurisdiction, may contain thousands of transactions in a given month unrelated to the taxpayer under examination. An agent considering summons must weigh the need for information – and the likelihood it is to be found – against
(1) the potential difficulty of finding pertinent transactions buried in a mass of unrelated transactions,
(2) the potentially high cost of reimbursing the bank for the production and copying costs, and
(3) the likelihood that the bank will resist the summons on behalf of its respondent and the respondent's other clients who may consider that their privacy is being violated.

Because of these concerns, an agent should not serve a summons on a U.S. correspondent bank for records of a correspondent account unless the agent has clear evidence that a taxpayer, or an entity the taxpayer controls, had at least one transaction that involved the correspondent account in question.

This requires ***"following the money"***. By examining the backs of cancelled checks, you can trace their route. At the Chips (wire service) website: www.chips.org, you can search by country and bank for the identity of U.S. correspondent banks having relationships with your taxpayer's offshore bank. Once you confirm that your taxpayer had a transaction that cleared through the correspondent account, you may issue a summons to the bank for all documents relating to the correspondent account for the relevant period.

Service of Summons

Instructor Notes

Please see PowerPoint slides 43, 44, and 45.

How to Serve

A copy of the summons must be properly served on the person summoned, either in hand, by delivery to the person's last and usual place of abode, or by certified or registered mail if the summoned party is a third-party record-keeper.

Service on a corporation must be made on a corporate officer, director, or other person authorized to accept service on behalf of the corporation.

The reverse side of the original Form 2039 (rev. 12-2001) contains a certification section, also called an attestation statement, whereby the serving party indicates how the summons was served and certifies that proper notice was given to any person entitled to notice. It also requires the serving party to state how notice was given, either by certified or registered mail, by being deposited at the noticee's last and usual place of abode, in hand, left with the person summoned, or notice was not required. All copies served on the person summoned must contain original signatures, the title of IRS official serving the summons and a certification statement that it is a true and correct copy of the Form 2039.

Read

IRC § 7605 (a).

Appearance Dates

The appearance date for a third-party summons must be at least 26 calendar days from the date the summons is served, because 23 days are provided for the noticee to quash the summons and 3 days provided for notifying the noticee. IRC § 7605(a) provides that a minimum of eleven days is required for a summons that is <u>not</u> a third-party summons.

If the summons is NOT a third-party summons, under IRC § 7605(a):

- You must allow **at least** 11 calendar days for appearance. (Additional time can be allowed, if necessary).
- Count the days from service date to the appearance date.

Continued on next page

Appearance Dates (continued)

If the summons is a third-party summons:

- Once the summons has been served (service date), the Service has 3 calendar days to notify **all** persons ("noticees") identified in the summons that a third-party summons has been issued.
- A noticee has up to 20 calendar days after the notice has been given to file a petition to quash the summons.
- This begins the 23 calendar day period within which a "noticee" may begin a proceeding to quash a summons.
- This will allow the noticee ample time to **quash** the summons, if desired.
- You will need to state on the "Certificate of Service" section of the summons the date that notice was given to the "noticee".

Requests for Additional Time To Appear Or Produce Records:

- If the person summonsed or their representative requests additional time to appear or produce records, discuss the request with Counsel and your group manager.
- Generally this is allowable, but if they request more than 30 additional calendar days it is advisable to use an "installment" arrangement where they agree to provide a portion of the documents on specific dates.
- All agreements regarding extensions of time or the rescheduling of testimony should be in writing in a letter to the witness.

Selecting an appearance date:

- Appearance date should be at least 26 calendar days from the summons service date.
- Keep it simple – use a date that is 30 calendar days from the service date.
- If the calculated appearance date falls on a weekend or holiday – advance the date forward to the following **work day**.

A representative of the witness cannot appear in lieu of the witness.

Continued on next page

Read

(Mimick v. United States, 952F.2d 23098th Cir. 1991)

Mimick Attestation Requirements

The Mimick case requires an attestation statement on the copy of the summons that is served. The statement attests that the person serving the summons compared the original summons to the copy of the summons served, and the copy served is a true and correct copy of the original.

The Mimick attestation statement is already preprinted on current versions of the summons Form 2039. The agent should make and retain of copy of the signed attestation statement for the case file.

The following is how the attestation statement appears on the summons copy given to the person being summoned:

> "I hereby certify that I have examined and compared this copy of the summons with the original and that it is a true and correct copy of the original".

The copy of the summons being served should contain the original signature and title of the IRS official serving the summons. (Note: The IRS official that serves the summons may be a different person than the agent that issued the summons).

The Certificate of Service on the back of the original summons requires that the IRS official that served the summons certify that the summons served contained the attestation required by IRC § 7603.

The attestation statement is not needed on the copy of the summons that will be provided to the "notice".

Additional information concerning the attestation requirements can be found in IRM 25.5.3.2.

Continued on next page

Mimick Attestation Requirements (continued)

Attestation statement procedures:

- The Mimick attestation statement is printed on the copy to be served. Check that the copy to be served is the same as the original summons.
- The serving official will sign and date the attestation statement on the copy of the summons to be served.
- Serve the summons bearing the original signed attestation statement.
- Retain the original summons.
- Make and retain a copy of the summons with the signed attestation statement for the case file.
- Both the original summons and a copy of the summons served with the signed attestation statement will be needed to enforce the summons.

Procedures

IRC § 7603 provides procedures for the service of a summons And defines a “third-party record-keeper”. Detailed instructions concerning the service of a summons can also be found in IRM 25.5.3.2. Although many summonses are issued to third parties, only specified types of third parties who keep records are third-party record-keeper.

As third-party record-keeper summons can be served by certified or registered mail using the last known address of such record-keeper. The term “third-party record-keeper” includes banks, credit bureaus, credit card companies, brokers, attorneys, accountants, regulated investment companies, enrolled agents, a barter exchange, and the owner or developer of a computer software source code. Additional explanation of these categories can be found in the Code as well as in IRM 25.5.6.3.2.

All other summonses, must be served by hand-delivering the summons to the person to whom it is directed (“personal service”). If, however, the summoned party cannot be located for personal service, it is permissible to serve the summons by leaving it at the person’s last and usual place of abode. This method is only to be used for a summons issued to an individual, and only when the summons is issued to that person in his or her capacity as an individual.

Continued on next page

Procedures (continued)

A last and usual place of abode is where the person actually resides. It is not where the person works. It differs from a "last known address". What matters is where the person actually lives. There are two methods for leaving a summons at the last and usual place of abode. They are:

- After locating the last and usual place of abode, you can leave the summons with a competent person who is of suitable age (defined as one who is age 16 or older) and who understands the importance of the document you leave. Try to find out the name of the adult and the adult's relationship to the person summoned. Write this information on the Certificate of Service.
  - If the person refuses to take the summons, drop it at his or her feet, and state that it is an Internal Revenue Service summons and that it is an important legal document.
- If no one answers the door, place the summons in the IRS official white "confidential" envelope. Write the summoned person's name on the envelope and attach it securely to the door. If this method is used, it is advisable to also mail a copy of the summons to the individual. See *Schindler*, DC Calif., 92-2 USTC.

If you cannot find a last and usual place of abode, you cannot use this method of service. If a person establishes that the service address was not the last and usual place of abode, they have a defense to enforcement of the summons. If service is defective, the summons is not enforceable.

If it is dangerous for you to go to the door, or it is impossible for you to do so (i.e., house is surrounded by a fence with a locked gate), it is permissible to tape the summons securely to another place, but only if it is reasonable to believe that the taxpayer will find the envelope and summons. On the Certificate of Service, write down where you left the summons and how you secured the summons.

Continued on next page

Summons Issued to a Corporation or Other Entity

A summons issued to an officer of a corporation is not equivalent to a summons issued to an individual. An agent cannot leave a summons issued served on a corporation at an individual's residence. The summons must be personally served on the officer or given to a person authorized to accept service of the summons on behalf of the corporation. Do not leave the summons with a receptionist, unless you first verify that the receptionist is authorized to accept service. If so, document your workpapers with name and phone number of the receptionist and the receptionist's statement.

If the summons "issued to" portion identifies the corporate representative who is to be served, you must serve that person.

Example 12B – 6

"Issued to: ABC Corporation, Ken Jones, President" or
"Issued to: Ken Jones, President, ABC Corporation"

If the summons "issued to" portion names only the corporation but does not identify the corporate representative who is to be served, you may serve any Officer, Director, or other person authorized to accept service.

Service on an Entity

You must serve the entity's representative (corporate officer, etc.) in person. You may do this wherever the entity's representative is found (at the corporate office, at home, or anywhere). It is not permissible to leave the summons at the entity representative's last and usual place of abode. Nor is it permissible to leave the summons at the entity's office for the entity's representative to get when he or she returns. This is true even if the "issued to" portion on the summons states the entity representative's name before the entity's name. Where the person is named in the person's representative capacity, the person is being served on behalf of the entity, and there is no "last and usual place of abode" for an entity. See, IRM 4022.7(4) and (5).

How do you find the name of the entity representative to serve?

Continued on next page

Service on an Entity (continued)

Often you will know the name of the entity's representative based upon research already done. Other times, you will need to find it. Do not simply call the entity and speak with anyone who answers the telephone. It is best to call the entity's legal department, explain that you have a summons to serve, and get the complete name, title, and business address of the person you are to serve. Get the information from someone who you believe is in a position to know the information is correct. It is usually best to call that person to confirm.

Contact the Office of the Secretary of State where the entity is incorporated or conducts business to determine if the company has a designated agent for service of process on record. If so, you may serve that individual. Many large corporations prefer service by that method. When you contact the entity, you should inquire if it has a designated agent for service of process.

If you are serving a summons on an entity or individual who is not within your immediate area, you need to coordinate with other IRS personnel to serve the summons. Although only certain IRS employees have been delegated the authority to issue a summons, any IRS employee can serve a summons.

Notice of Third-Party Summons

IRC § 7609(a) provides that the agent issuing the summons has 3 calendar days from the date the summons is served to give notice to a "noticee" that the summons has been served. Part C of the Form 2039 is the copy of the summons that is used to provide notice; Part D is used as the cover letter that will accompany the notice. The notice is sent by certified or registered mail. To avoid any dispute over proper notice, a copy of the notice should also be given to the power of attorney. Further, the Certificate of Service section on Form 2039 must reflect the date that notice was given to the noticee. This date begins the 23-day period within which a noticee may begin a proceeding to quash the summons.

The noticee is usually either the person who is identified in the summons or attachments, or the person whose records are sought in the summons. There may be more than one person entitled to notice, especially when dealing with spouses. However, because notice is given only for a third-party summons, notice is not required if a summons meets an exception to the third party notice requirements.

Continued on next page

Notice of Third-Party Summons (continued)

Notice is given to the taxpayer under examination, the “responsible person”, the corporate or partnership employer, and every person or entity identified in the summons and attachments.

- The taxpayer under examination always receives notice of service of a third-party summons.
- If an account identified in the summons is owned by both a husband and a wife, both husband and wife are entitled to separate notices, even if they reside at the same address.
- If a domestic account is in the name of a trust (foreign or domestic), but the taxpayer has control over the trust, in addition to giving notice to the taxpayer, notice should also be given to the trustee of the trust, even if the trustee is located in another country.

Notice is required because the noticees have the right to move to quash the summons, and have intervened in summons enforcement proceedings.

Notice of a third-party summons must be given within 3 calendar days of the date the summons was served on the witness.

How is notice given?

- The notice must include a copy of the summons, but an original signature is not required.
- The notice must be sent by certified or registered mail.
- Sign the Certificate of Service showing that you gave notice of the third-party summons.
- Third party notice is given only for a third-party summons. If a summons is not a third-party summons, notice is not required, regardless of whether other taxpayers are named in the attachments.

Continued on next page

Read

IRC § 7609(e).

Petition to Quash

A noticee who wishes to prevent compliance with the summons of a third-party may begin a civil action in U.S. District Court to quash the summons.

The Petition to Quash must be filed no later than the 20th calendar day after the day the notice of summons is given appliances.

Revenue Agents must notify Associate Area Counsel **by telephone** of a Petition to Quash:

- On the **same day** and,
- **Within six workdays**, forward to Associate Area Counsel a memorandum report which includes the following:
  - The name, address and TIN of the taxpayer under investigation.
  - A summary of the facts.
  - An explanation of why the summoned information may be relevant to the success or completion of the examination.
  - All information that would support or refute the validity of each assertion in the petition to quash.
  - A recommendation for or against defense of the petition to quash the summons.
  - The original summons and a copy of the petition to quash the summons.

Note: If a motion to quash is filed, IRC § 7609(e) may toll statute of limitations.

Continued on next page

Read

IRC § 7609(d).

Receipt of Records Prior to the Due Date of Summons (23rd day)

The requested records may be submitted prior to the date shown on the summons. If this occurs, the **records must remain sealed** until the taxpayer's ability to initiate a petition to quash the summons has expired. Do NOT examine any records produced before the close of the 23rd day after notice has been given **or** if a timely proceeding to quash has begun. You may not look at these documents until the time period for filing a motion to quash has passed. Timely filing a petition to quash prevents the Commissioner from examining any summoned records while the proceedings are pending. IRC § 7609(d).

You cannot examine records provided pursuant to a summons if either of the following applies:

- Twenty-six days have not yet passed from the service date. IRC § 7609(d); or
- The taxpayer files a motion to quash. IRC § 7609(d).

Once the time period has elapsed for filing a motion to quash, you may review and copy the summoned records.

- Do NOT make any markings on the original documents.
- Make copies of the summoned records for the case file and a work copy, if necessary.
- If an owner of the records requests the return of the records before all copies have been made, **copying of the taxpayer's records must cease immediately.**
- The Service is generally entitled to retain any copies that are made before the owner requests the return of the originals.
- Copies made before the owner makes a request for the return of his or her records must be dated with the name of the person making the copies.

Summons Enforcement

Instructor Notes

Important section. See PowerPoint slides 65 through 69.

Read

IRC §§ 7210, 7402(b), 7404(a) and 7604.

Non Compliance with Summons

If a summonsed party refuses to produce documents or give testimony pursuant to a summons, the IRS may seek judicial enforcement of the summons in U.S. district court. See IRC § 7402(b) and 7604(a). A summoned party who fails to comply with a summons may be subject to:

- Criminal proceedings under IRC § 7210.
- Civil proceedings under IRC § 7604 to enforce compliance.

Contact Area Counsel and request enforcement of the summons if the summoned party did not comply with the summons, fully or partially. The court's role in is limited to determining whether the summons is a legitimate exercise of the IRS's investigative authority. The court will not question review the wisdom of the IRS' investigative decisions.

Case Law

To prevail in a summons enforcement action the government only has to make a “minimal” initial showing that the summons satisfies the Powell requirements.

The government’s prima facie showing typically is made through an affidavit or declaration of the IRS agent who issued the summons. U.S. v. Gilleran, 992 F.2d 232 (9th Cir. 1993); Liberty Financial Services v. U.S., 778 F.2d 1390 (9th Cir. 1985).

Once the government establishes its prima facie case, the burden shifts to the party opposing the summons.

Continued on next page

Enforcement Procedures

If you make a summons referral, forward Form 4443, Summons Referral, to your Area Counsel with:

- The original summons.
- A copy of the service copy of the summons reflecting the signed Mimick attestation statement.
- A clear statement of the nature of your examination and why this summons was issued.
- Facts of service.
- Facts of compliance or noncompliance.
- Explanation of unusual items requested.
- Facts of bankruptcy, if applicable.
- Facts of Fifth Amendment or other privilege claim.
- If the summoned party has indicated he/she will not comply with the summons, forward this information to the attorney and detail the nature of the discussion.
- How you know that you served the summons at the last and usual place of abode (if this was the form of service).
- If you used a pseudonym. The pseudonym requires modification of your Declaration for Court. The Court must be informed if you used a pseudonym (but no need to reveal your true name).
- If you already have any of the summoned documents, prepare a list specifically identifying each summoned document already received. If possible, also show the source of each document and date received.
- Describe any potential statute problems.

Once a summons has been referred to Area Counsel for summons enforcement, the agent will be asked to write and sign a Declaration of Agent. The Declaration of Agent must reflect:

- Compliance with the Powell standards (the facts showing the reasonableness of the summons).
- Facts of the agent's Mimick attestation.
- Facts of service of the summons.
- Facts of summoned person's partial compliance or noncompliance with the summons.
- Any unusual circumstances.

Continued on next page

Enforcement Procedures (continued)

If the court orders the witness to comply with the summons the government must bring contempt proceedings if the witness refuses to comply. A summons does not toll the statute of limitations, so you should issue the summons early in your examination. You must also make any summons referral to Area Counsel as soon as possible following noncompliance.

If the summoned party complies with the summons before the enforcement proceeding, enforcement is moot.

Effect on Statute of Limitations

Neither service of a summons nor its enforcement tolls the statute of limitations. There are exceptions if a third-party summons is being enforced.

If, in the case of a summons is a third-party summons and the noticee files a motion to quash the summons, or intervenes, the statute of limitations on assessment, collection, and criminal prosecution is tolled. IRC § 7609(e) (1).

- Tolled for the period the summons enforcement action and any appeals are pending.
- Tolled with respect to the person taking the action to move to quash or intervene in the summons enforcement proceedings.
- Tolled for the period from six months after the summons service date to the date of final resolution of such response.
- If there is no resolution of the summoned party's response to the summons within six months of the summons service date, the statute of limitations on assessment, collection, and criminal prosecution is tolled. IRC § 7609(e) (2).
- Tolled with respect to any person with respect to whose liability the summons is issued.

Formal Document Requests

Instructor Notes

Please see PowerPoint slides 72 through 76.

Read

Read IRC § 982.

When to Issue

Taxpayers sometimes refuse to furnish foreign information, claiming the IRS has no right to records outside the United States. More often, taxpayers may claim the records do not exist, cannot be obtained, or cannot legally be provided. Foreign law, foreign languages, foreign business practices, foreign recordkeeping practices, jurisdictional questions, and distance all contribute to the difficulties that you may have getting information.

Formal Document Requests ("FDRs") f encourage a taxpayer to comply with a request for documents located outside the U.S. If the examiner has previously issued Information Document Requests ("IDRs") for foreign-based records, and the taxpayer has failed to produce all of the foreign records requested, it may be necessary to issue a formal document request.

A formal request for foreign based records should only be made after exhausting all other reasonable methods of obtaining the necessary information from the taxpayer or, other domestic sources.

Foreign document requests require the taxpayer to choose between giving foreign-based records to you or not using them later in court.

IRC § 982(a) cannot force a taxpayer to produce foreign-based records, but prohibits the taxpayer from introducing any foreign-based documentation covered by the request. IRC § 982(a) is a shield, not a sword.

Continued on next page

Use with Summons

Because an FDR is only a shield, you may choose to use both a sword and a shield at the same time. In that case, you would issue an FDR and a summons simultaneously for the same records. This is especially advisable if:

- The location of the documents is not certain, or
- You suspect the taxpayer may move documents into the United States to avoid complying with an FDR or out of the United States to avoid a summons.

Follow the separate procedures for FDRs and summonses. You may issue both the FDR and summons on the same date.

Procedures

Before issuing an FDR, there are two requirements that must be satisfied:

- The normal request procedures must have been used, and
- The taxpayer must have failed to produce the documents.

The FDR:

- Can be "**any request**",
- Can be mailed by registered or certified mail, and
- Will be sent to the taxpayer's **last known address**.
- Applies to books and records located "outside the United States".

There is no a special form for making the request. IRM 4233, Exhibit 500-10, instructs you to use Form 4564 and a cover letter and includes a pattern for the cover letter.

Because the FDR will be sent to the taxpayer's **last known address**, you must be sure you mail the FDR to the latest address the taxpayer has given the Service, not the address on the tax return.

Continued on next page

Content Requirements

The FDR must be mailed by registered or certified mail to the taxpayer's last know address, and must set forth:

- The time and place for the production of the documentation;
- A statement of the reason the previous production (if any) was insufficient;
- A description of the documents now being requested; and
- The consequences to the taxpayer if he fails to produce the described documents.

For the *first requirement*, remember that IRC § 982(a) specifies the date be the 89th day after mailing. The place usually should be the taxpayer's place of business or where the examination is being conducted. Both the time and location must be reasonable.

For the *second requirement*, it is helpful to attach a copy of the previous request (original IDR) to make the statement clear.

For the *third requirement*, you must be sure the FDR does not request more records than the IDR issued previously. If additional records are necessary, an additional (second) IDR must be issued, to be followed by a second FDR, if necessary. As with any request for foreign records, you may require:

- Original records be provided, and
- Translations into the English language be furnished.

For the *fourth requirement*, state that the Government will invoke IRC § 982(a) in any future litigation on these tax issues.

Continued on next page

Read

IRC § 982(d). Please note that this section only applies to:

Definition

- Books and records
- Located “outside the United States”.

Thus, you may not issue an FDR to interview someone. However, “books and records” are to be interpreted broadly, extending to any and all accounting records and company data. These records only need to be either “relevant” or “material”. Either justification will do, or both are broad terms.

“Books and records” also includes documents held by a foreign entity whether or not controlled by the taxpayer.

Counsel Review

Exhibit 500-10 in IRM 4233 requires that Area Counsel review all FDRs before issuance. Local procedures may require other reviews as well. If you anticipate issuing an FDR, you should contact Area Counsel for advice on the wording.

Substantial Compliance

Once a formal document request has been issued to the taxpayer, the taxpayer has 90 days to comply. If the taxpayer fails to *substantially* comply with the FDR, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall prohibit the taxpayer from introducing any foreign-based documentation covered by the request.

If a Court Determines	***Then***
compliance has not been substantial,	none of the records requested are admissible, not even those provided to the Service.
compliance has been substantial,	all requested records are admissible, even those not provided to the Service.

Extension of 90-day Period

The taxpayer may request an extension of the 90-day time limit to respond. Either the Service or a court with jurisdiction over a taxpayer’s petition to quash a formal document request may grant an extension.

Continued on next page

Instructor Notes

Please emphasize the procedures for the petition to quash and see PowerPoint slide 77.

Petition to Quash

A taxpayer may attempt to quash an FDR within 90 days of mailing of the FDR. The motion to quash is accomplished by the taxpayer filing a petition in court. Once in court on the taxpayer's petition to quash, the Service may seek to compel compliance with the request and a court can order the taxpayer to comply.

While court action on a petition to quash is pending, the 90-day period for compliance is suspended. The statute of limitations also is suspended while court action and any appeals on a petition to quash are pending.

If you learn that the taxpayer has filed a petition to quash an FDR, IRM 4233, Exhibit 500-10 instructs you to:

- Notify the Office of District Counsel by telephone the same day,
- Send a written recommendation for defense of the petition to the Office of District Counsel within six working days, and
- Include in the recommendation whether the Service should seek to compel compliance with the formal document.

Continued on next page

Read

IRC § 7402 and 7602.

Consent Directives

CCDM (34) (12)3(10).

A consent directive is a court order directing a taxpayer to sign a document directing a foreign bank, trustee, or other entity or individual believed to have control over documents of the taxpayer, to turn them over to the IRS. Consent directives are appropriate when the Service suspects a person has signature authority over a tax haven bank account or trust and the person denies it. Consent directives originated in a 1984 decision, *United States v. Ghidoni*, 732 F.2d 814 (11th Cir. 1984).

The consent directive does not force a taxpayer to acknowledge he has an account or the like, but simply requires a taxpayer to sign a document addressed to the foreign entity which requires that if the taxpayer has foreign records under the specified entity's control, the foreign entity is to release those records to the IRS.

While a summons issued under IRC § 7602 may not be used to compel a taxpayer to execute a consent directive, the desired result may be effected by issuing summons to the taxpayer requesting production of the records sought in the bank summons. While not in his possession, the taxpayer has custody and control of the records and can be ordered to comply with the summons by either producing the books and records himself, or by signing a consent directive authorizing the bank to produce the records on his behalf.

Therefore, when the IRS seeks production of foreign bank records, a summons should be issued to the taxpayer for the records. If the taxpayer fails to produce the records and the Government files a petition to enforce the summons, the Government may ask the district court to order the taxpayer to sign a consent directive that is limited to records held by foreign banks. Such an order is within a district court's authority under IRC § 7402. CCDM (34) (12)3(10).

Although it may take time and effort to have a court issue a consent directive, it can be an effective tool in obtaining records that are offshore. To the extent a taxpayer refuses to comply with a consent directive entered by the court, he is subject to contempt proceedings, which could result in fines and/or imprisonment.

Privileged Communications

Instructor Notes

Please see PowerPoint slides 78 through 87.

Read

IRC § 7602.

IRM 25.5.10.2(3).

Fifth Amendment Privilege

The Fifth Amendment to the Constitution provides that no person shall be compelled to be a witness against himself. However, incriminating information provided voluntarily by an individual may be used.

IRC § 7602 authorizes the Service to summon taxpayers and third parties to testify and to produce books and records. However, if answering a question would tend to incriminate the witness, that person may refuse to answer under the Fifth Amendment. In contrast, the Fifth Amendment privilege does not apply to voluntarily created, pre-existing documents, because the Government did not compel that person to create them. The act of producing those documents may be subject to a Fifth Amendment claim, because the mere act of production compels that person to tacitly admit that the documents exist, are in that person’s possession, and believes the documents produced are those required by the summons.

Whether tacit admissions may tend to incriminate witness will depend on the facts and circumstances of each case. Consequently, under the act of production exception, even voluntarily created, pre-existing documents may be protected. This could occur if a taxpayer (or other person) is summoned to produce the records a sole proprietorship.

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Fifth Amendment Privilege (continued)

IRM 25.5.10.2(3) provides guidelines for dealing with a summoned taxpayer or witness who claims the Fifth Amendment or other privilege.

- In this situation, continue with the interview or examination.
- Ask all questions and request all documents, so the person asserting the privilege responds to each inquiry.

If the person summoned refuses to submit to questioning and the requests for documents, stop the interview.

- A record should be made of the interview.
- Another IRS employee should attend the interview or examination as a witness.

Procedures

Follow these procedures if the witness raises the Fifth Amendment privilege:

- Make a question-by-question inquiry. Ask every interview question.
- Require the summoned person to claim the Fifth Amendment for each response.
- The witness should not claim a blanket Fifth Amendment privilege to cover questions not yet asked because the witness may later claim the question would have been answered, if it had been asked.

Continued on next page

Who Can Claim the Privilege?

The Fifth Amendment only protects INDIVIDUALS.

- If the summons is issued to obtain corporate or other entity records, the corporation or other entity cannot claim a Fifth Amendment privilege.
- The privilege against self-incrimination under the Fifth Amendment does not apply to corporations because the state, having created the corporation, has reserved the power to inquire into its activities, and an inanimate corporate body should not be afforded the same protection as a natural person in avoiding incrimination.
- If the summons is issued to an individual in his or her capacity as a representative of a corporation or other entity, or as a custodian of the entity's records, the Fifth Amendment does NOT protect the individual, Bellis v. United States, 417 U.S. 85, 88 (1974); even if the corporation is dissolved, Wheeler v. United States, 226 U.S. 478, 489-90 (1913).
- The Fifth Amendment does not protect an individual partner who holds partnership records in a representative capacity, even if the partnership is dissolved. Bellis v. United States, supra.
- The Supreme Court has held that an individual cannot rely upon the privilege against self-incrimination to avoid producing the records of a collective entity that are in his or her possession, even if these records might incriminate him or her personally. Partnership books and records are not the personal property of an individual; they are collective property of a group of persons.
- Partnership books and records voluntarily submitted by one partner may be used in evidence against the other partners without violating their constitutional rights.
- The Fifth Amendment does not protect an individual who holds trust documents in a representative capacity. United States v. Field, 193 F.2d 92, 96 (2d Cir. 1951) [Summons issued to trustee for trust documents]; United States v. Matthesson, 77-1 USTC & 9351 (C.D.C.A. 1977) [trust documents held by someone other than a trustee].
- A trustee can be directed to comply with a summons which calls for the production of certain books and records of the trust. Since the trust is a separate entity, the trustee can not claim the Fifth Amendment privilege. The books were held in a representative capacity rather than a personal capacity.

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Who Can Claim the Privilege? (continued)

- If records are held in a representative capacity, and the records relate to the entity, the Fifth Amendment does not protect the individual, even if producing the records would incriminate the individual. United States v. White, 322 U.S. 694, 699.
- BUT: If the Summons relates to a sole proprietorship, the sole proprietorship has no legal existence apart from the individual, and the Fifth Amendment claim may be valid for the individual.
- A corporate officer may not refuse to produce corporate records held by him or her in an official capacity, even though their production may incriminate him or her or the corporation.

Overview

There are certain special types of relationships in which information communicated by one person to the other is held confidential and privileged between them. This privilege may exist between:

1. Attorney and Client,
2. Federally Authorized Tax Practitioner and Taxpayer, or tax advice privilege,
3. Husband and Wife,
4. Clergyman and Penitent, and
5. Psychotherapist-Patient.

For our purpose, we are going to discuss only the attorney-client privilege and tax advice privilege.

Attorney-Client Privilege

In general, communications between a taxpayer and attorney to secure legal advice are privileged, and the attorney cannot be compelled to disclose that information to the Service.

Also, if the taxpayer creates records to facilitate the exchange of privileged communications with the attorney, those records are privileged. However, if a taxpayer turns over pre-existing records to an attorney, the Service can obtain those records, unless they were otherwise privileged from production while in the taxpayer's possession.

The Attorney-Client privilege can be waived only by the client.

Continued on next page

Attorney Work Product Privilege

The work product privilege is limited to protecting "materials prepared by an attorney 'acting for his client in anticipation of litigation.'" United States v. Nobles, 422 U.S. 225, 238 (1975) (citing Hickman v. Taylor, 329 U.S. 495, 508 (1947)). The purpose of this doctrine is to prevent the forced disclosure of the attorney's litigation strategy and the materials he develops to further that strategy. United States v. Nobles, 422 U.S. at 237. While the doctrine protects material prepared by both the attorney and his agents (id. at 238-239), it is clear that the materials must be prepared in anticipation of litigation and not in the ordinary course of business. See United States v. Rockwell International, 897 F.2d at 1265- 1266; United States v. El Paso Co., 682 F.2d at 542; Simon v. G.D. Searle & Co., 816 F.2d 397, 401 (8th Cir)., cert. denied, 484 U.S. 917 (1987).

- Protects communications/materials prepared by the attorney showing the attorney's thought processes, legal theories, and strategy for the case.
- The privilege can also apply to communications/materials involving those working on behalf of the attorney, including an accountant hired by the attorney.

Continued on next page

Read

IRC§ 7525.

Tax Advice Privilege

RRA 1998 added IRC § 7525 providing for a special privilege for communications between a “federally authorized tax practitioner” and his or her taxpayer/client in civil matters concerning “tax advice” to the same extent the privilege would apply if the communication were between a taxpayer and an attorney. It applies to communications on or after July 22, 1998.

- Before RRA 1998, no "accountant/client privilege" existed.
- “Federally authorized tax practitioners” are the persons described in Circular 230 as subject to regulation (i.e., CPAs, attorneys, enrolled actuaries, and enrolled agents).
- “Tax advice” means any advice given “with respect to a matter which is within the scope of the individual’s authority to practice”.
- It may be asserted “to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney”.
- The privilege does NOT apply to written communications made “in connection with the promotion of the direct or indirect participation of the person in any tax shelter”.
- This privilege does NOT cover information disclosed only to enable preparation of a tax return.

The new privilege does not arise automatically but must be asserted by the taxpayer. Service employees may still seek the same information in the same manner as before. The only difference is that taxpayers may now assert, in non-criminal proceedings, a confidentiality privilege for communications made after the date of enactment to federally authorized tax practitioners concerning tax advice sought or received.

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Privilege Logs

Privileged communications cannot be obtained by issuing a summons. If a summoned party refuses to produce information in response to a summons on the grounds that the information sought is privileged, a privilege log must be provided by the summoned party. The privilege log should contain a brief description of the contents of the document or communication, the date the document was prepared, the name of the person who prepared the document, the name of the person to whom the document was directed or for whom it was prepared, its purpose, and the specific privilege asserted.

Summary

Instructor Notes

Please see PowerPoint slides 88, 89, and 90.

1. The summons is a tool available to obtain relevant information that cannot be obtained through other means.
2. Though not legally required, request the information from the taxpayer in writing (using an IDR) prior to issuing a summons.
3. IRC§§ 7602, 7603, 7604 and 7609give IRS the authority to issue, serve, and enforce summonses.
4. Summons enforcement may be necessary if the summoned party refuses to comply with a summons.
5. The request for summoned records must be detailed and meet enforcement requirements.
6. There is a 23-day waiting period on summonses issued to third parties.
7. Do not make extraneous notes on the original summons as it may be used in enforcement proceedings.
8. An owner of records who voluntarily produces records in response to a summons may, at any time, request their return. Therefore, when the records are received, copy them immediately.
9. In the description of records on Form 2039, try to avoid the use of general, overbroad, and vague terms, as they invite an attack on the summons as being unreasonable.
10. IRS Publication 1, which provides notice of potential future Third Party Contacts, must be delivered to the taxpayer prior to issuance of a third-party summons.
11. When any examination purpose summons is issued to any third party for records or testimony, both the taxpayer and any other person identified in the description of the records to be produced must generally be given notice of the summons within 3 calendar days of the day on which the summons is served.

Continued on next page

12. A formal document request (FDR) is used to obtain foreign-based records when a taxpayer has failed to produce all of the foreign records requested in Information Document Requests (IDRs).
13. An FDR cannot force a taxpayer to produce foreign records, but will prohibit the taxpayer from introducing any foreign-based records covered by the FDR.
14. If a summoned party claims the Fifth Amendment privilege, the agent should ask every interview question and require the summoned party to claim the privilege for each response.
15. RRA 1998 added IRC § 7525 which provides for a special privilege for communications between a “federally authorized tax practitioner” and his or her taxpayer/client in civil matters concerning “tax advice” to the same extent the privilege would apply if the communication were between a taxpayer and an attorney.

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Exercises

Exercise 1

A Revenue Agent summoned the taxpayer to provide a copy of his 2006 Form W-2. Under the Powell standard, is the Revenue Agent justified in summonsing this information?

Answer: No.

You may not request documents "already in possession" of the IRS. You may not request W-2's, 1099's, or past tax returns unless you can demonstrate that a reasonable inquiry was made and you failed to locate the document(s). U.S. v. Bank of California, 652 F.2d 780, 783 (9th Cir. 1980).

Exercise 2

A Revenue Agent summoned the taxpayer to create a spreadsheet categorizing taxable and nontaxable bank deposits. Is the Revenue Agent justified in summonsing this information?

Answer: No.

A summons may not request a summoned party to create a document. Only pre-existing documents may be summoned. The Revenue Agent should instead summons the monthly or periodic account statements for a specified period, including deposited items, to determine taxable and nontaxable deposits.

Exercise 3

A summons can be mailed to a taxpayer. True or false?

Answer: False.

A summons to the taxpayer must either be:

- Hand delivered to the person to whom it was directed,
- Left with a competent person of suitable age and discretion at the last and usual place of abode of the person to whom it was directed with instructions that the summons be given to the person summoned, or
- Affixed to the front door of the summoned party's last known place of residence.

Continued on next page

Exercise 4

For a third-party summons, the Service is generally required to notify the taxpayer and any other person identified in the description of the records that a summons has been served within ____ day(s) of the service.

A) 1
B) 2
C) 3
D) 4

Answer: C. 3 calendar days

The Service is required to notify the taxpayer and any other person identified in the description of the records that a third-party summons has been served, within 3 days of the service.

Exercise 5

If a summoned person claims the Fifth Amendment during an interview, you should:

A) Continue with the interview
B) Stop the interview.
C) Tell the person the Fifth Amendment does not apply to Taxation

Answer: A.

Continue with the interview and ask all interview related questions.

International Technical Training

Chapter 13

Permanent Establishments (PE)

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• One hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide • Participant Guide • O.E.C.D. Model Treaty • IRC § 894 • IRC § 7852(d)(1)-(2) • Treas. Reg. 1.894-1(b) • IRC 864
Participant Materials	• Participant Guide • Pencils/Pens • Highlighters
Participant References	• O.E.C.D. Model Treaty • IRC § 894 • IRC § 7852(d)(1)-(2) • Treas. Reg. 1.894-1(b) • IRC 864
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides prepared by Instructor • Flipcharts and markers • Transparency markers • Overhead projector

Continued on next page

Instructor Information, Continued

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and Power Point slides.

Overview

Introduction

The United States is a party to over 70 bilateral income tax treaties (either in force or being negotiated). The purpose of tax treaties is to *avoid double taxation*, and simplify the taxation of issues between countries. In general, treaties and statutes have the same legal status; however, under IRC § 894(a), in determining the tax liability of any taxpayer, regard must be given to any treaty obligation of the United States. Furthermore, no provision of the Code may apply with respect to any treaty obligation in existence on August 16, 1954, if the Code provision would be contrary to a treaty. However, if a Code provision is enacted subsequent to August 16, 1954, the Code prevails (unless legislative history conclusively proves otherwise).

Read IRC § 894 and IRC § 7852(d) (1)-(2).

- Under **IRC § 894(a) and Treas. Reg. 1.894-1(a)**, income of any kind is excluded from gross income to the extent required by a treaty to which the United States is a party.
- **IRC § 7852(d) (1) and (2)**. Note that under IRC § 7852(d) (2), if treaty provisions and the Code conflict, superiority is given to the treaty if it was in effect on August 16, 1954. The treaty applicable to a particular transaction may not be the most current version of the treaty. If an issue arose before the current treaty entered into force, then the previous treaty will apply for most purposes.

A determination of whether a foreign corporation or other person has a PE will depend upon the specifics of the treaty provisions covering PEs between the foreign company or individual home country and the United States. Equally important is how the treaty provisions are interpreted and applied to each case.

The structure of U.S. treaties is fairly uniform. All of our treaties have a section dealing with PE. However, in the case of the U.S.-U.S.S.R. treaty, PEs are referred to as “representations”. Likewise, all U.S. treaties have an agency exception to the PE definition. Each treaty contains a section allowing activities to be carried on through an independent agent without being classified as a PE (discussed in depth later in this module). *Accordingly, for a PE issue, the place to begin is with the U. S. Model Treaty.*

Continued on next page

The United States Model Treaty

The United States uses the 1996 Model as a basis for negotiating new income tax treaties. Prior to 1996, the United States published a model in 1981 which it withdrew as an official model in 1992. The 1996 U.S. Model and Technical Explanation are generally patterned after the 1992 O.E.C.D. Model Tax Convention (updated in 1995) and the extensive commentaries to the O.E.C.D. Model. For treaties with developing countries, the United States may adopt certain provisions patterned after the United Nations model treaty. Differences between the developed and developing country treaties are discussed below.

Pre-OECD Treaty Definition of Permanent Establishments

You should be careful when dealing with older United States treaties. These older treaties are shown in the table below. As stated earlier, *it is important to determine which version of a treaty is applicable at the time of the transaction at issue*. Issues frequently arise relating to years subject to provisions of older treaties, especially if the treaty has been renegotiated recently. These treaties came into effect prior to any O.E.C.D. models being available. As a result, these treaties have an older version of what constitutes a PE.

Treaty Country	Year Treaty Signed
Austria	1956
Denmark	1948
Greece	1953
Ireland	1949
Pakistan	1957
Switzerland	1951

Continued on next page

Old Treaties vs. New Treaties

In as much as the newer treaties were patterned after O.E.C.D. models, there are differences between the new and old treaties. Specifically,

- Agency will constitute a PE if the agent has full power for the negotiation and concluding of contracts or have a stock of merchandise from which they regularly fill orders.
- Warehouses and storage facilities are defined in different terms except for the United States-Pakistan treaty which does not mention warehouse or storage facilities. Our treaties with Austria and Switzerland exempt from PE status the maintenance of a warehouse for convenience of delivery and not for purposes of display. The treaties with Denmark and Switzerland also state that a PE does not include the casual or temporary use of mere storage facilities.
- The United States-Switzerland treaty goes one step further and includes important agency language that maintaining a warehouse for convenience of delivery and not for purposes of display will constitute a PE.

The treaties with Denmark, Greece, Ireland, and Pakistan require the foreign entity do business through a commission agent in order to avoid PE.

United Nations (U.N.) Model Treaty

The United Nations Model Treaty defines PE in the same manner as the O.E.C.D. Models. However, the United Nations model adds provisions regarding furnishing of services which includes consulting services. These services constitute a PE when they are engaged in within a 12-month period. A provision classifying insurance enterprises as PEs is also included in the United Nations model. If an issue arises in the area of services, the United Nations treaty can be a source of information.

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Analyzing Treaties

As previously stated, a search for the factors constituting a PE should begin with the 1996 United States Model Treaty. The Commentary to the O.E.C.D. Model (Commentary) is the basic source for interpretation of PE in conjunction with the legislative history of the treaty for whatever country is being considered. The Commentary provides explanations of the various articles in the O.E.C.D. Model. However, if the treaty is an older version, the 1963 O.E.C.D. Model Commentary may be useful.

In both the U.S. and O.E.C.D. models, PE is covered in Article 5. This article defines a "PE." Furthermore, the article describes the "independent agent" exception. Finally, Article 5 discusses the parent company's control over a subsidiary company.

Conclusion

All the model treaties, particularly the O.E.C.D. model, have had an impact on the evolution of the 1996 United States Model Treaty. Accordingly, the United States model is the starting point of a PE issue.

Objective

At the end of this lesson, you will be able to:

- Determine whether a foreign entity doing business in the U.S. has a PE.
- Analyze Treaty Articles dealing with PEs.
- Determine the proper taxation of the business profits of a treaty country taxpayer doing business in the U.S.
- Understand the law as it relates to a foreign entity from a non-treaty country doing business in the U.S.

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Overview

League of Nations

In 1928, the League of Nations organized a group of experts from several countries whose work led to the publishing of the "Model Conventions for the Avoidance of International Double Taxation and Fiscal Evasion". In 1946, the League published the "Model Bilateral Conventions of Mexico and London" which defined Permanent Establishments and clarified when one exists.

Organization of European Economic Cooperation (O.E.E.C.)

The definition of a Permanent Establishment (P.E.) was again addressed in 1958 by the Fiscal Committee for European of the O.E.E.C. (Organization for European Economic Cooperation, also known as the Common Market). This committee further defined PE and addressed the concept of agency within the definition.

Organization of Economic Cooperation and Development (O.E.C.D.)

The O.E.E.C. later expanded to include non-European countries, including the United States. The name was then changed to "Organization of Economic Cooperation and Development" (O.E.C.D.). The O.E.C.D. continued to develop the concept of PE.

The O.E.C.D. formulated the following:

- Draft model treaty (1963), and
- The Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital (1977).

Continued on next page

Contents

This lesson covers the following topics:

Income Affected by Treaties

Reading Assignment

Read IRC 894(a) and Treas. Reg. 1.894-1(a).

Under IRC § 894(a) and Treas. Reg. 1.894-1(a), income of any kind is excluded from gross income to the extent required by a treaty to which the United States is a party. Exceptions are the:

- Determination of accumulated taxable income of a foreign corporation under IRC § 535,
- Determination of undistributed personal holding company income of a foreign corporation under IRC § 545, and
- Determination of the distributable net income of a foreign trust.

Treas. Reg. 1.871-12 provides guidance in determining the tax liability of a foreign corporation that has a reduced gross income due to the application of a treaty provision.

Read 894(b) and Treas. Reg. 1.894-1(b).

IRC § 894(b) states that for a PE in the United States which received income **not** effectively connected to a trade or business in the United States, the income will be treated as though a **PE did not** exist. This law applies to treaties entered into on or before November 13, 1966 (the date of the enactment of the Foreign Investors Tax Act of 1966).

Treas. Reg. 1.894-1(b) states, “This paragraph is not considered to be contrary to any obligation of the United States under an income tax convention to which it is a party”. IRC § 894(b) can best be illustrated by the exercise below.

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Exercise 1

Fairfield, Inc. (Fairfield) is a corporation organized in Trinidad but doing business in the United States and is a calendar year entity. The United States and Trinidad are parties to an income tax treaty which provides, in part, that:

> *"Dividends received by a Trinidad corporation, from U.S. sources, when a PE does not exist in the United States, are subject to tax at a rate of 15 percent".*

During 1999, Fairfield is engaged in a business in the United States through a PE and received $100,000 in dividends from Elko, Inc., a U.S. corporation. Fairfield has taxable income from operations of $50,000.

Assuming a tax rate of 34 percent, what is Fairfield's tax liability in the United States and why?

Answer:

$15,000.00 assuming the $50,000 TI is not effectively connected income. Using reduced treaty rate on Dividends as outlined in Reg 1.894-1(b) (2) example (1).

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Definitions

- **Permanent Establishment:** The model Income Tax Treaty defines a PE as *"a **fixed place of business** through which the business of an enterprise is wholly or partly carried on",* such as: offices, factories, mines, and places of management.
- **Fixed:** Requires that a permanent establishment "must be established at a distinct place with a certain degree of permanence".
- **Place of Business:** Any premises, facilities or installation used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose.

Obviously, a "fixed place of business" can be many different things. It does not have to be a building; however, ideally the fixed place of business is in a business office or building. If, in the fixed place of business, the activities include only preparatory or auxiliary activities (for example, gathering or dispensing information, advertising, etc.) are performed, these activities will **not** constitute a PE.

O.E.C.D. Commentary

The commentary makes several points concerning a fixed place of business:

- A fixed place of business covers any premises, facilities, or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose.
- A place of business may also exist where no premises are available or required for carrying on the business of the enterprise.
- A place of business is simply a certain amount of space.
- It is immaterial whether the premises, facilities or installations are owned or rented.

The equipment constituting the place of business does not have to be fixed to the soil.

- Maintaining a fixed place of business to supply spare parts to customers for machinery supplied to such customers is a PE. Also, a location where machinery is maintained could be a PE.
- Supplying plans specially developed for the individual customer would be more than an auxiliary activity.

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O.E.C.D. Commentary (continued)

The commentary also notes that the mere leasing by a lessor of equipment, facilities, building, or intangible property will not constitute a PE of the lessor provided the contract is **limited** to the mere leasing of the equipment.

Examples of a PE

- A “sales pitch” area in a marketplace or flea market, or
- The premises of another enterprise, or
- Part of the premises of another enterprise.

Other Rules and Concepts

Rule/Concept	Explanation
“At-any-time” Rule	A taxpayer will not be exempt from U.S. tax if a PE existed at any time during the taxable year (particularly true with the United States-Switzerland treaty).
Office	Having an office requires some business activity be performed. However, the activity does not have to be formal. The Tax Court looks at an office as being staffed and having day-to-day activity.
Store or Other Sales Outlet	Other sales outlets can be a PE, e.g., showrooms or sales offices for solicitations of orders.
Branches	There are not any revenue rulings or case law dealing with branches; however, a Private Letter Ruling concluded that supplying a Japanese home office with data does not constitute a PE.

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Other Rules and Concepts (continued)

Rule/Concept	Explanation
Place or Seat of Management	Both terms appear in U.S treaties. The place or places where a business, on account of the types of decisions made there, would qualify for tax residence. On the other hand, a “place of management” does not include a hotel room temporarily occupied by visiting executives making technical or scientific decisions on a temporary basis. However, such a place of business could be a residence or hotel suite if management decisions are made there on a continuing basis.
Warehouses	The maintenance of a stock of goods in a warehouse in the United States for purposes of regular delivery by an agent appears to be a PE under older treaties. The O.E.C.D. treaties exempt from PE status, “the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise”.
Extraction of Natural Resources	The O.E.C.D. Commentary states that a “place of extraction of natural resources” should be interpreted broadly. Furthermore, a place extraction includes both on-shore and offshore locations; however, the mere ownership of a place of extraction is not sufficient to give rise to a PE. The newer treaties consider installations and drilling rigs, ships, etc. used on one contracting state for a specified period of time to constitute a PE. For example, the United States-Australia treaty states that drilling equipment being used for an aggregate of six months during a 24-month period will constitute a PE.
Rental Real Estate	The leasing by a lessor of commercial property does not make the property a fixed place of business if there is an independent agent; however, use of a dependent agent will cause the taxpayer (lessor) to have a fixed place of business.

Continued on next page

Income Affected by Treaties, Continued

Other Rules and Concepts (continued)

Rule/Concept	Explanation
Construction or Assembly Projects	Under the O.E.C.D. treaties, a building site or construction project will constitute a PE if it lasts more than 12 months; however, treaties vary on the number of months required to establish a PE. The developing countries prefer shorter periods due to the substantial investment of capital into their countries. You should verify what the duration is in the treaty for the country being considered. Special attention should be paid to the interplay between a building site, construction site, or installation project vs. maintaining equipment.
Building Sites	The term “building/construction site” includes construction of roads, bridges, canals, laying pipelines, excavating, and dredging. Planning and supervision of a construction site are covered in this category if performed by the building contractor; however, if planning and supervision are performed by another enterprise, those activities, are not considered part of the PE.

Reading Assignment

Read O.E.C.D. Model Treaty – Article 5, Paragraph 4.

Continued on next page

Exceptions Not Deemed PE

Exception	Description
4a.	The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise.
4b.	The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery.
4c.	The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.
4d.	The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise.
4e.	The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

E Commerce

Treasury's current position, as set forth in its 1996 White Paper entitled, "Selected Tax Policy Implications of Global Electronic Commerce", is that the United States should apply existing principles to taxing electronic commerce. The following are examples of transactions applying current taxation principles with and without electronic commerce, i.e., the Internet. This is an emerging issue and, as such, there is not any case law. Also, the subject is not addressed in any treaty.

Example 1: No Internet Sales

Without the use of the Internet, Country X company sells cookware through the use of a store located within Country Y. The store employs sales professionals to make presentations in customers' homes, take orders, and arrange for the Country Y store to process and ship the cookware. The store is responsible for billing and collection. This is an example of a PE.

Continued on next page

E Commerce (continued)

Example 2: Internet Sales

Sales professionals are no longer necessary. Instead, the company maintains an interactive website leased on a local server in Country Y. The site is capable of producing virtual demonstrations of its products and can answer questions. The company directs advertising at Country Y consumers via the website on the local server.

The computer server in Country Y is capable of notifying the computer in Country X of entire transactions, as well as when and to whom to ship products. The computers are capable of processing customer billings.

Country Y can tax the Country X company only if the company maintains a PE pursuant to the treaty between Countries X and Y. The issue is whether the automated website the company maintains and uses to sell its cookware constitutes a PE in Country Y.

The O.E.C.D. has recently proposed draft language taking the position that a website would not create a PE, but depending on the facts, a server might create a PE for a non-resident.

Dependent Agent

If an agent is dependent on its principal and has authority to conclude contracts, the agent creates a PE. The O.E.C.D. has recently proposed draft language taking the position that an Internet Service Provider normally will not create a PE by agency for an enterprise whose website it hosts.

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Conclusion

The fact that a website constitutes:

- The conduct of business activities within a country by means of the equivalent of a fixed place of business, or
- A virtual presence in the nature of a dependent agent, may lead to the conclusion that the website is a PE. Consider the ramification of the nonexistence of a PE. A retailer of any country can do business in any other country via the internet with or without the permission of anyone. Therefore, the Country X company described above can sell their goods anywhere in the world without having to consider the tax consequences thereof.

Agency and/or Business Relationships

An area where many potential issues arise is an exception to being a PE contained in the Independent Agent provisions of Article 5 of the 1996 U.S. Model Treaty and the 1977 O.E.C.D. Model Treaty.

Sales or other business activities can be conducted in the United States in virtually unlimited volume provided:

- Business dealings are limited exclusively to bona fide commission agents, brokers, or other independent agents,
- Acting in the ordinary course of *their* business, and
- They receive standard commissions for services performed.

The independent agent concept is thus important because it confers an exemption from taxation of U.S. business profits even though a substantial trade or business is being conducted in the United States.

The determination of whether or not an agent is dependent or independent is contingent on the ***contract*** between the agent and the foreign business entity. The amount of control the foreign enterprise exercises over the agent has no bearing on the status of an agent. An independent broker or agent should not work exclusively for one foreign enterprise in order to establish an independent agency relationship.

Agent's Authority

The older treaties require an agent to have "general authority to negotiate and to conclude contracts". The newer O.E.C.D.-based treaties require:

- The agent to have absolute authority to conclude contracts, and
- The agent must **habitually** exercise the contracting authority within the contracting state,

On behalf of the foreign principal.

In the older treaties, a PE was brought about if the agent had no contracting authority but habitually maintained a stock of goods or merchandise belonging to the foreign enterprise from which he/she made deliveries or filled orders on behalf of the enterprise.

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Agent's Authority (continued)

The term "**habitual**" requires activity or the intent to continue in the activity. The operation needs to be through a resident agent whose activities were considerable, continual, and regular.

Legally and Economically Separate

The Commentary to the 1977 O.E.C.D. Model Treaty specifically states that an independent agent will be independent only if the agent is legally and economically independent from the enterprise. In dealing with developing countries, you should be particularly aware of the provision requiring an exclusive agent to be independent only if the transactions between the agent and foreign enterprise are at arm's length. In addition, the independent agent should bear risk of loss. The United States-Barbados treaty is an example of this provision. The treaty states, "When the activities of such persons (independent agents) are devoted substantially on behalf of that enterprise, **he shall not be considered an agent of independent status within the meaning of this paragraph if the transactions between the agent and the enterprise were not made under arm's length conditions".** The arms length provision in the U.S. treaties with a developing country is a compromise between the United Nations Model Treaty and the United States Model Treaty.

Read Model Treaty Article 5, Paragraphs 5 and 6.

These paragraphs contain the exception to being classified as a PE. The exception relates to the classification of "**independent agent**". All U.S. treaties will have such a provision. Treaties will refer to independent agents as:

- Brokers,
- Commission agents, or
- Custodians.

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Legally and Economically Separate (continued)

This article states that if a person (**other than** an *independent* agent) acts on behalf of a foreign enterprise and has habitually exercised the authority to bind the foreign enterprise to contracts, this person (**a *dependent* agent**) will constitute a PE. However, if the dependent agent's activities are:

1. preparatory, or
2. auxiliary (to be discussed later),
3. his/her activities will not constitute a PE.

If such an agent exists, it is not necessary to find a fixed place of business of the foreign enterprise to argue the existence of a PE. An independent agent must be acting in the ordinary course of business. You should be aware that certain treaties, particularly those with lesser-developed countries, do not consider agents independent if their activities are devoted substantially to one enterprise and business dealings are not at arm's-length. The following treaties require arm's-length dealings for independent agents:

- Barbados,
- China,
- Jamaica,
- Philippines, and
- Sri Lanka.

The treaties also describe the activities of **dependent agents**. The early treaties concluded that a dependent agent would constitute a PE of the enterprise if the agent habitually exercised authority to:

- Negotiate and/or conclude contracts,
- On behalf of its principal, or
- Maintained a stock of merchandise from which the agent filled orders on behalf of the foreign entity.

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Legally and Economically Separate (continued)

The O.E.C.D. treaties are generally the same as the early ones, except a dependent agent will **NOT** constitute a PE if he/she habitually exercises authority, but only to the extent of purchasing goods or merchandise for the foreign enterprise.

A Dependent Agent is one who assumes no risk and an Independent agent is one who assumes risk or shares in the assumption of risk.

Preparatory and Auxiliary

Under the O.E.C.D. Commentary, “preparatory and auxiliary” activities in a fixed place of business do **not** constitute a PE. The Commentary elaborates on what is meant by “preparatory and auxiliary”:

> *“It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question”.*

The Commentary finds the decisive criteria to be whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

Continued on next page

Activities Not Considered "Preparatory and Auxiliary"

*Certain activities cannot be preparatory and auxiliary and thus **establish** a PE:*

- A "fixed place of business" performing identical operations to those of the whole enterprise constitutes a PE. If servicing of patents and know-how is the purpose of the enterprise, then a fixed place of business performing such work constitutes a PE.
- A fixed place of business performing management of an enterprise, or even a part of the enterprise or of a group, cannot be considered preparatory and auxiliary.
- A PE will normally exist if an enterprise operated internationally establishes a "management office" where the enterprise maintains subsidiaries, PEs, agents, or licensees if that office conducts supervisory and coordinating functions for all departments of the enterprise located within a region.
- Where a large international concern has delegated all management functions to its regional management offices with only general supervision in its head office, each of those regional offices constitutes a "place of management".
- The function of managing an enterprise, even if it covers only a certain area of operations, constitutes an essential part of the business operations of the enterprise, and it cannot be preparatory or auxiliary.

Income Attributable to a Permanent Establishment

Read U.S. Treaty – Article 7, Paragraph 1.

You ***must first*** determine whether there are taxable business profits or taxable income attributable to the potential PE ***before*** any search for a PE is started. Otherwise, a substantial amount of examination time can be expended in establishing the existence of a PE when there is not any income.

In the United States, a foreign corporation is generally taxable on its income effectively connected to business conducted within the United States. In most cases, a physical presence in the United States would satisfy this requirement; however, if a tax treaty with a foreign country applies, this may not be the case.

Tax treaties provide for net taxation. In the absence of a PE in the United States, business profits are not taxed because the treaty, unlike the Code, normally exempts them from source country taxation.

Article 7, Paragraph 1 of the United States Model Treaty states, "The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated herein. If the enterprise carries on business as aforesaid, the business profits of the enterprise **may be taxed in the other State** by only so much of them as are attributable to that permanent establishment".

Business Profits

Business Profits are defined in the U.S. Treaty under paragraph 7 as *"income from any trade or business, including income derived by an enterprise from the performance of personal services and from the rental of tangible personal property".*

What to tax per the **Code** under IRC 864 and IRC 882:

- Gross income effectively connected to a U.S. Trade or Business
- Less: Direct and Allocated expenses
- U.S. Source NECI FDAP on a Gross basis.

Continued on next page

Business Profits (continued)

What to tax per the **Treaty**:

- Business profits (NET) attributable to a PE
- Permanent Establishment

Two-pronged test for Business Profits:

- The foreign entity or individual must be carrying on a business through a PE in the U.S. in order to have taxable business profits, and
- Those business profits are taxable ***only*** if they are attributable to that PE.

Personal Services as Business Profits

A consulting firm resident in one Contracting State whose employees perform services in the other Contracting State through a PE may be taxed in the other State on a net basis under Article 7. Be aware that Article 14 deals with Independent Personal Services which would not be applicable here, inasmuch as Article 14 applies only to individuals. The salaries earned by employees of the consulting firm would be subject to the rules of Article 15 (Dependent Personal Services).

Business profits of a PE are determined as if the PE were dealing independently with its headquarters office or other branches of the parent enterprise. No business profits are attributed to a PE by reason of a mere purchase by the PE of goods or merchandise for the enterprise.

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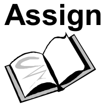
Arm's Length

The general rule is that a contracting state will attribute to a PE the profits it would have earned had it been an independent enterprise engaged in the same or similar activities under the same or similar circumstances. This is reminiscent of IRC § 482, i.e., the treaty language incorporates the arms-length standard for purposes of determining the profits attributable to a PE.

However, this does not mean that either the Service or the taxpayer may apply IRC § 482 in determining the taxpayer's business profits and disregard the application of the Code for computing effectively connected income. On the contrary, both the taxpayer and the Service must apply the Code rules for determining effectively connected income. Thus, if a PE exists, but the sole services provided by that PE are executive management functions for the remainder of the business enterprise, it is not possible to attribute income to the PE, assuming such services would not generate effectively connected income under the Code. Similarly, if a PE exists, but the sole activity of the PE is to trade in stocks or securities for the taxpayer's own account, no income may be taxed under the business profits article since no income may be taxed as effectively connected income under the Code. This is because the activity is not one constituting a trade or business in the United States under IRC § 864(b) (2).

Reading Assignment



Read IRC § 864(c) (2) (A) and (B).

IRC § 864(c)(2)(A) and (B) states: *"the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or the activities of such trade or business were a material factor in the realization of the income gain or loss".*

As can be seen, the "asset use test" and "business activities test" of the Code have been incorporated into the 1996 United States Model Treaty. It is interesting to note that the O.E.C.D. Model Treaties do not include such language in Article 7. This provision was added to the United States model to make it clear the limited "force-of-attraction" rule of IRC § 864(c) (3) was not incorporated into the United States Model Treaty.

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Net Business Profits

Business profits of a PE are determined under the Model Treaties after allowing deductions for expenses incurred for the purposes of the PE. In Article 7, Paragraph 3, this is referred to as “taxation on a net basis”. These deductions include:

- Executive and general administrative expenses,
- Research and development expenses,
- Interest, and
- Other expenses incurred for the purpose of the enterprise as a whole.

In addition, this rule is not limited to expenses incurred exclusively for the PE, but includes a reasonable allocation of expenses incurred for the enterprise as a whole, or that part of the enterprise which includes the PE.

Expenses should be allowed regardless of which accounting unit of the enterprise deducts them as long as they are incurred for the purposes of the PE.

Expenses are allowed whether incurred in the Contracting State in which the PE is located or elsewhere.

Read Article 7, Paragraph 7.

Business Profits are broadly defined in Article 7, Paragraph 7 to mean ***income derived from any trade or business***. The business profits attributable to a PE are the business income of the entity or its industrial and commercial profits. All of these types of income are taxable to the PE **if** they can be **attributed** to the operations of that PE.

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Special Rules

You should understand that Article 7 of the Model Treaties takes *precedence over* Articles 10 through 13 (relating to dividends, interest, royalties, and gains from the sale of property). Under Article 7, these passive income items become active income if they are otherwise business profits. Therefore, they become part of the taxable income of the PE and are taxable on the same net basis as described above. You will recognize these types of income as being FDAP (fixed or determinable or annual or periodical) income subject to withholding tax on a gross basis. The treaty characterizes these types of income as business profits, taxable on a net basis to a PE in contrast to gross withholding tax treatment.

Non-Treaty Taxation of Business Profits

As previously stated, there are two concepts which form the basis for U.S. taxation of foreign persons and/or entities doing business in the United States:

- PE with attributable business profits, and
- Persons/entities engaged in a trade or business with effectively connected income (ECI).

If a foreign corporation or person:

- Is engaged in a U.S. trade or business, or
- Has a U.S. PE,

it is taxed as if it were a U.S. corporation/person, but only on:

- ECI, or
- Business profits associated with a PE.

The table below reflects the rules for dealing with taxpayers in either a treaty country or a non-treaty country:

Type of Country	Rule
Treaty	Start with the rules under IRC § 864(b) and (c) or special Code rules for insurance and global trading companies. Treaty rules may limit the amount of profits attributable to the PE. Special issues, law, etc. will be derived from the applicable treaty.
Non-Treaty	Look to IRC §864(b) and (c) and special Code rules for insurance and global trading companies to determine if: • The person or entity is engaged in a trade or business in the United States, and • Whether or not there is ECI.

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The ideal case can be in either of two forms:

- A fixed place of business must be established, or
- A dependent agent must be found to give the foreign company a fixed place of business.

It is critical, however, that you **first** identify the type of activity giving rise to income attributable to a PE. Otherwise, finding a fixed place of business or a dependent agent will be of no examination value.

Fixed Place of Business

The ideal case would have a distinctly identifiable place of business, such as a branch office or factory. This place of business should also have a certain degree of permanency as opposed to a temporary nature. There should be strong evidence of day-to-day management of the U.S. operations by an employee of the foreign company.

Activities

This ideal case would also have a business activity that is a significant element in earning income. Examples of that type of significant activity are intense sales activity or service activity within the United States. Open negotiation of contracts and the signing of contracts by employees of the foreign company in the name of the foreign company in the United States would also be relevant to establishing a PE.

Market research and development, purchasing, and information-gathering activities would be relatively minimal or nonexistent in the ideal case. This would help to eliminate arguments from the taxpayer that their activities were merely “preparatory and auxiliary”. In the ideal case, there would also be no issue as to whether the foreign company was only warehousing or storing its goods for display or delivery.

Dependent Agent

If the foreign enterprise does **not** have a fixed place of business, the second type of ideal case is to locate a dependent agent. In the ideal case, the foreign enterprise would direct and control the dependent agent’s activities and the foreign enterprise would make decisions for the agent including decisions on day-to-day operations.

Summary

1. In 1928, the League of Nations organized a group of experts from several countries whose work led to the publishing of the "Model Conventions for the Avoidance of International Double Taxation and Fiscal Evasion". In 1946, the League published the "Model Bilateral Conventions of Mexico and London", which defined PE.
2. The United States is a party to over 70 bilateral income tax treaties. The purpose of tax treaties is to avoid double taxation, avoid tax evasion, and simplify taxation issues between countries. In the United States, treaty obligations and domestic tax law are of equal status.
3. The United States uses the 1996 Model Treaty. The U.S. model is patterned after the O.E.C.D. Model.
4. Under IRC § 894(a) and Treas. Reg. 1.894-1(a), income of any kind is excluded from gross income to the extent required by a treaty to which the United States is a party.
5. Both the O.E.C.D. and U.S. models define PE in the same manner. A PE requires a place of business, the place of business must be fixed, and the business of the enterprise must be wholly or partly carried on through the fixed place of business.
6. The "**independent agent**" concept is important because it confers an exemption from taxation of U.S. business profits even though a substantial trade or business is operated in the United States.
7. You must first determine whether there are taxable business profits or if taxable income exists before a search is undertaken for a PE. There are two concepts which form the basis for U.S. taxation of foreign persons/entities doing business in the United States: (1) PE with business profits, and (2) persons/entities engaged in a trade or business with effectively connected income.
8. Under IRC § 864(c)(3), if a foreign enterprise has a trade or business in the United States, the U.S. source income will be effectively connected to the trade or business of the enterprise and thus taxable on a net basis.

Please refer to the Permanent Establishment Technical Advisors Website for additional information and reference materials at: http://lmsb.irs.gov/hq/pftg/permestab/index.asp.

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Summary, Continued

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

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Class Exercises

Answer True or False.

Exercise 1 The United States uses the 1981 Model as a basis for negotiating new income tax treaties.

Answer: False

Exercise 2 For a facility to qualify as a PE, it must be owned by the Foreign Company.

Answer: False

Exercise 3 A dependent agent does not assume any risk.

Answer: True

Exercise 4 An independent agent should not work exclusively for one foreign enterprise in order to establish an independent agency relationship.

Answer: True

Exercise 5 A difference in the older treaties and the newer O.E.C.D. based treaties is the contracting authority of the agent.

Answer: True

Exercise 6 If a dependent agent's activities are preparatory in nature, then the activities do not constitute a PE.

Answer: True

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Exercise 7

All treaties consider agents independent if their activities are devoted to one enterprise.

Answer: False

Exercise 8

If there are no taxable business profits or taxable income but there is a PE, then you need to develop your issue further.

Answer: False

Exercise 9

Business profits are taxable whether or not they are attributable to the PE.

Answer: False

Exercise 10

Business profits are determined after allowing deductions for expenses incurred for the purpose of the PE, including a reasonable allocation of expenses incurred for the enterprise as a whole.

Answer: True

Job Aid: Audit Steps in Examination of a Protective Return

I. Preliminary review and analysis

Procedure	Description
A.	Verify that the taxpayer has attached a Form 8833 to the tax return. To be a protective return, this form must be attached and Form 8833 must state that the taxpayer believes that it has no Business Profits attributable to a Permanent Establishment ("PE") in the U.S. in accordance with a particular treaty.
B.	Pull the specific treaty cited by the foreign corporation on F8833 and read the relevant Articles – primarily relating to business profits, permanent establishment and residence. Also pull any related Treasury Technical Explanation.
C.	A link to all treaties can be found on the Foreign Banking TA's website at: http://lmsb.irs.gov/hq/pftg/foreign_bank/index.asp. Alternatively, go to the IRS internet site and Search using the words "income tax treaty". http://www.irs.gov/ Accept the first choice given.
D.	Use Westlaw tabs: IRS Business & News for International News on your FC which may show activities in U.S. If, for example, they are contributing to a Wilkes Barre, PA charity, maybe they are indirectly advertising for business. If you can't access a resource there, contact Strategy, Research & Program Planning ("SRPP") for assistance and they will for you. (http://lmsb.irs.gov/hq/srp/index.asp
E.	Use a search engine, like Google™ to research the corporation. Contact SRPP to get an organization hierarchy list. That will show you who owns whom and who is related to whom. If you find activities related to a state or federal regulatory agency like the SEC, contact Government Liaison to secure material from that agency. (http://lmsb.irs.gov/hq/cl/new_liaison/fed-state.asp If you can't access Edgar™ through Westlaw, for SEC information, contact SRPP (http://lmsb.irs.gov/hq/srp/index.asp).
F.	If the FC is a bank, go on the web at http://www.ffiec.gov/nic and click on "Organization Hierarchy". This allows you to access the organizational hierarchy of every bank.
G.	Prepare to do a functional analysis. The best tool in a functional analysis is interviews in much the same way we audit the allocation and apportionment issues under T.R. 1.861-8 for both inbound and outbound taxpayers.
H.	Determine if any related entity has a trade or business in the U.S. or files any tax return in the U.S. To do that you can have your secretary do IDRS Research. You can also pull-down public information off of the internet.
I.	Consider pulling any related Forms 1120 in order to review schedule of transactions with this taxpayer.
J.	Review Lesson 4 of IVT presented on 4/14/04 on Form 1120F and Permanent Establishments. Order DVD from your Training Coordinator or read the transcript and look at the slides at http://tv.web.irs.gov/trngmatl/LMSB/LMSBmatl.htm.
K.	Review International training material from Phases II and III.

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Note: If there is no relevant income tax treaty, there can be no Permanent Establishment (“PE”) issue. If there is no relevant treaty, we return to Code standards exclusively. You would then determine if the foreign corporation is engaged in a trade or business in the U.S. and/or whether they had income subject to withholding.

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Job Aid: Audit Steps in Examination of a Protective Return,
Continued

II. Evaluating the treaty and its terms

Procedure	Description
A.	Always start with the specific treaty a foreign entity is citing to on the Form 8833 for guidance.
B.	The first place to look for an interpretation of a particular treaty is the Treasury Technical Explanation to *that* treaty. If there is an Exchange of Notes or a Joint Committee Explanation, that will help as well.
C.	The U.S. Model Treaty (and Treasury's Technical Explanation) "is intended to facilitate negotiations and not to provide a text that the United States would propose that the treaty partner accept without variation. The U.S. Model conforms most closely to U.S. domestic law". Doc 96-25912 Treasury Dept. News Release, RR – 1273, Sept. 20, 1996; Doc 96-25868 Treasury Dept. Technical Explanation, Sept. 20, 1996.
D.	If after looking in the Technical Explanation to the specific treaty used, you are still unsure of an interpretation, you should then consult the U.S. Model Treaty, its Technical Explanation as well as the OECD Model Treaty and its Commentary.
E.	In litigation, the Courts might look to the OECD Model for guidance. However, the U.S. believes that the OECD guidelines and commentary are consistent with U.S. domestic law, or at least reconcilable.
F.	Because there are variations in each treaty, for purposes of this audit plan, reference will be made to the U.S. and OECD Model Treaties and its Technical Explanation or Commentary.
G.	First determine if there are any taxable Business Profits (or even gross income) "attributable to" the potential PE before a search for a PE is started. This is practical because if there are none, it may not necessarily be a good utilization of resources to argue that the corporation has a PE, depending on priorities.
H.	Review the Business Profits definition contained in Article 7 of the 1996 U.S. Model Treaty. 1. Article 7, paragraph 7 – "income from any trade or business, including income derived by an enterprise from the performance of personal services, and from the rental of tangible personal property". 2. Ibid, paragraph 2 regarding separate entities and transfer pricing – "…the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment". (Compare this language with the language in the T.R. 1.864-4(c) (1) tests for U.S. source FDAP as ECI).
I.	Verify business profits in much the same manner as you would determine how much a foreign corporation has in effectively connected income: through a functional analysis. The biggest difference is that Business Profits is a net number and ECI is a gross number.

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Procedure	Description
J.	Review the definition of a Permanent Establishment contained in Article 5 of the U.S. Model Treaty and the OECD Model Treaty.
K.	Since the activities carried out by a dependent agent can create a PE for the principal, it is important to determine if there is such a party. That person may often be found working at a subsidiary or branch of another but related entity. U.S. and OECD Model Treaty, Article 5.
L.	Administratively, if there are no Business Profits attributable to a PE, some might think we'd be wasting our time looking for a PE. However, if the foreign corporation says that they would have an NOL if it were determined they had a PE, audit those figures first. Since Business Profits is a net number, that means verifying gross income as well as allocable and direct expenses.
M.	Consider, in conjunction with your SBSE Compliance Technical Advisor (3rd party contact coordinator) and Area Counsel, and your LMSB Technical Advisor and LMSB Area Counsel, when you will need to prepare a Notice of Third-Party contact in relation to some of the interviews. The link to find your SBSE CTA is http://sbse.web.irs.gov/collection/programs/3rdparty/3rdpartycoordinators.htm. The link to the LMSB PE Technical Advisor is: http://lmsb.irs.gov/hq/pftg/permestab/index.asp.

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III. Initial Interview with a representative of the foreign corporation.

Procedure	Description
A.	Ask what led them to believe they might have a PE and file a protective return, including whether this was the result of consultation with an attorney or accountant. They don't have to tell you the conversation they had with an attorney. You are merely soliciting whether this was prompted by such a conversation.
B.	Solicit the corporation's version of the facts leading them to consider filing a protective return.
C.	Ask the interviewee if they computed the amount of income and expenses they believe they would have to report if it were determined that they had either a PE or a trade or business in the U.S. If so, record same for future reference.

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IV. The Functional Analysis – a generic approach. Determine if there are taxable Business Profits or income attributable to a potential PE.

Procedure	Description
A.	Determine from the corporate representative who in the company would have first-hand information about the operation of the foreign corporation ("FC") and its related entities. In rare cases this will be the tax representative. It is more likely to be the head of the department in charge of overseeing the business of the corporate group in North America.
B.	Discuss the nature of the FC's business operations regardless of where they say they were performed.
C.	What is the function of each department/officer of the FC and the related U.S. entities? Try to get some official descriptions before delving further. They might even appear on the corporation's website.
D.	What everyday business records are kept by the FC and where are they kept? Where is the second set, which would be used in the event of a disaster, kept?
E.	Do they have any transactions with any related or affiliated entity that files a U.S. tax return? Ask them to provide information similar to that which is provided on a Form 5472.
F.	Is the foreign corporation engaged in any joint ventures of any kind with any related or controlled entities that file a U.S. tax return? This information might be mentioned on their website. It might also appear in a news article which could be found either through Lexis™ or Westlaw™.
G.	Review all payments between the foreign corporation and related U.S. entities.
H.	Does anyone in the U.S. perform any services whatsoever for the FC? Determine if that person has authority, either expressed or implied, and exercises this authority to negotiate and execute agreements/contracts on the FC's behalf. Determine whether that person is a dependent agent or independent agent.
I.	You are searching for income which, by definition, is very similar to ECI so use those concepts. Business profits include only the profits that are derived from the assets or activities of the PE. So, for financial services PEs, we are looking for the furnishing of services, income attributable to notional principal contracts, and the like. This includes deferred compensation. This might even involve the Global Dealing regulations 1.482-8 if there is a global book for any product line such as notional principal contracts.
J.	Determine if the FC has any clients in the U.S. and, if so, how they procured them. We might want to consider summonsing certain large clients to see how the business was actually generated.
K.	Both the Service and the FC must apply the Code rules for determining ECI. Therefore, trading in stocks or securities solely for the FC's own account cannot be taxed as Business Profits because it would not be taxed as ECI. IRC § 864(b) (2). Similarly, in most cases, the sourcing rules for the Code are applied to potential Business Profits. IRC § 861-864.

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V. Helpful Resources

Procedure	Description
A.	Look at Tasei Fire & Marine Ins. Co. v. Commissioner, 104 TC 535 (1995) and North West Life Assurance Company of Canada v. Commissioner, 107 TC No. 19, filed December 12, 1996, for further assistance and interpretation.

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Handout 1: *Possible IDR Questions for Use in the Examination of 1120F and Form 8833*

For the year(s) under audit:

1. Please provide an organization chart of your group's worldwide operation. Include on it, in addition to subsidiaries, partnerships and joint ventures, any companies that you have control over, or that you have a right to control, that have a presence in the United States ("Hierarchy"). The term "control" is used as it is defined in the regulations under IRC § 482.
2. Please provide an organization chart for each of your U.S. subsidiaries, partnerships, and joint ventures. This should detail the breakout of all employees by division, department, section, etc.
3. Please provide an organization chart of your legal entity. This should detail the breakout of all employees by division, department, section, etc.
4. Please provide an Annual Report for you as well as any certified or audited financials that are not spelled out in the Annual Report.

If any of these documents is not in English, please translate same.

5. Who in your company has first-hand, contemporaneous knowledge of your business dealings with parties located in the United States? Those dealings should include any business conducted with your U.S. subsidiaries, affiliates, partnerships, and joint ventures. The person(s) may be, for example, in The Americas Division, or have a similar title or function. The person(s) may be responsible for managing an operation having to do with a region that includes the United States.
6. Please make that person or those persons available for interview about those business dealings.
7. If a translator is necessary, please provide one.
8. Briefly describe the nature of your worldwide business, on an entity by entity basis, regardless of where activities were performed.
9. State the names of your biggest customers situated in the U.S. The term "your biggest customers" should include any clients that you share with another entity or person. State how you procured these customers.

Continued on next page

10. Through whom and with whom did you conduct any business in the United States? State the name(s), title, and business address (es) of the person or entity.
11. Describe the facts that led you to consider filing a protective return or the facts provided that led another to advise you to file a protective return.
12. Have you made any preliminary determination as to what income and what expenses would be attributable to a U.S. PE if, in fact, it were determined that you had a U.S. PE? Please provide those numbers and the individual categories that make up those numbers (i.e., rent, interest income, interest expense, commissions, etc.).
13. Did your company file any U.S. regulatory reports or requests, such as with the SEC, the Federal Reserve, etc.?
14. Please provide a list or computer run of all of your general and subsidiary ledger accounts. If they are not in English, please translate the account names.
15. Please state whether or not you have any bank accounts, including correspondent accounts, in the United States. If so, in which banks are these accounts located?
16. Please state whether or not you have brokerage accounts in the United States. If so, with whom are these accounts located?
17. Please state whether or not you have any representatives in the United States. If so, please describe their role and responsibilities. If this is formalized in writing, please provide a copy of the said executed agreement, translated into English if it is not already in English.
18. Do you have any ledger account(s) reflecting transactions between you and any of your U.S. subsidiaries, affiliates, partnerships, and joint ventures, or any services provided? If so, please provide detailed information about them. Such information may be provided in the form of a computer run. Are any of these accounts in machine-sensible form? Please provide the same information which would normally be reported on a Form 5472.

Continued on next page

19. Have you made any transfers of property to any U.S. person during the audit year(s)? If so, please provide details of those transactions including, but not limited to, the nature of the asset; the transferee with its address, the date of the transfer, the use of the asset by your business prior to transfer; and the amount received from the transfer.
20. Have any U.S. persons made any transfers of property to you during the audit year(s)? If so, please provide details of those transactions including, but not limited to, the nature of the asset; the transferor with its address, the date of the transfer, the use of the asset by your business after transfer; and the amount paid for the transfer.
21. Would any of the transactions noted above be recorded by or reported to a third-party such as a regulatory agency? If so, by or to whom?
22. On Form 8833, you have cited to the U.S.-(Country 1) Income Tax treaty but on the face of it, you appear to be a resident of (Country 2). On what basis do you claim you are a tax resident of (Country 1)? Please state your authority and enough specific details to support your position.

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Handout 2: *Permanent Establishment Interview Questionnaire*

The RA needs to understand how the TP's organization as a whole operates. Therefore, in-depth background information on the TP's business activities needs to be developed. This information may be obtained via the internet, SEC 10-K and through interviews with key personnel of the company. The type of information would include the following:

General Background Information Questions for Foreign Corporation's Executive Officer or Local Operations Manager of U.S. Operation

A) Secure a complete description of the business or businesses in which the TP (the foreign corporation filing the protective 1120F) is engaged in the United States, including a description of the industry within which the taxpayer operates.

(**Note:** The TP may be engaged in a U.S. business that reports on an 1120 like a subsidiary, or another business for which the TP files an 1120F. The Agent is inquiring about the TP's business which *does not have* reported income like the 1120F Protective Claims. RA may need to analyze several business ventures that TP operates in the U.S. to determine if a PE exists).

1. Describe product and/or service provided
   (a) If TP provides service, where are the services performed?
   (b) Who performs the services and who is the employer of the persons performing the services?
   (c) If TP sells products, does the TP sell wholesale or to end users (retail)?
   (d) Where does title pass?
   (e) Provide a description of the process for TP to deliver products to clients. Include in the description whose employees and/or agents perform the delivery process.
   (f) Are the products shipped to a U.S. warehouse or to someone in the U.S. *or* are they shipped directly to the client?
2. Determine who the major competitors in the industry are.

Continued on next page

General Background Information Questions for Foreign Corporation's Executive Officer or Local Operations Manager of U.S. Operation (continued)

3. Description of any intangibles developed and/or used by the taxpayer in this business.
4. Provide a complete list of locations where TP conducts business, has employees, or has offices or equipment:
   (a) What type of business is conducted at each of these locations?
   (b) Number of employees at each location?
   (c) If you have no employees, please provide a description regarding who conducts the business at each of the U.S. locations.
5. Does TP file any paperwork with any U.S. agencies (i.e., Customs, SEC)?
   (a) If so, please provide the names and titles of who would have access to any of this paperwork.
   (b) Identify the specific documents filed and the agencies with whom the documents are filed.
   (c) Where are these documents maintained and how are they retrieved?
6. Does the foreign TP have any related U.S. entities?
7. Do you have an organizational chart prepared on a legal entity basis and/or on a business operation/functional basis? Do you have an organizational chart prepared for tax purposes? If so, who prepares the chart and may we have a copy of it for the period under examination?
8. Does TP provide goods and/or services to any U.S. related entity or U.S. person? If yes, provide name/address/telephone number. (**Note:** Need to determine source of TP's income in U.S.)
   (a) What is TP's relationship to the U.S. related entity or U.S. person?

Continued on next page

General Background Information Questions for Foreign Corporation's Executive Officer or Local Operations Manager of U.S. Operation (continued)

9. Does the company have any assets, equipment or employees located at any U.S. related entity place of business or related U.S. person's residence or anywhere else in the United States?
10. How does a potential client come into initial contact with the company for the TP's product or services?
    (a) Is there a dedicated sales staff?
    (b) Is there a warehouse staff?
    (c) Where are the sales and/or warehouse staff located?
    (d) How many people work at each location?
    (e) What is their educational background?
    (f) Do they need any special training or knowledge to perform their sales or warehousing functions?
    (g) Who manages the sales personnel? Who manages the warehouse personnel?
    (h) Do the sales people visit with clients (potential and existing)?
        1. If so how often and for what purposes?
        2. (If applicable) Do the sales personnel meet with clients at the warehouse facility?
    (i) Do the sales personnel become involved with installation?
    (j) Is there a toll-free number the client calls?
    (k) Are there U.S. telephone numbers and faxes through which a customer can request the product or service? If so, where are the telephones and faxes answered? Whose employees answer the telephones and faxes?
    (l) Do you have a Web page from which a customer can order products?
    (m) Who developed this page?
    (n) Does the Web page make use of any company developed software or other intangibles? If so, who owns these intangibles?
    (o) Where is the Web page hosted?
    (p) What percentage of your U.S. business is conducted over the Internet?

Continued on next page

General Background Information Questions for Foreign Corporation's Executive Officer or Local Operations Manager of U.S. Operation (continued)

(q) Please describe a typical business contact from initial contact on the internet to the end of the transaction and identify the persons who perform the internet services and the physical locations of these persons.

(r) Do you have any shared service centers or dedicated support functions located in the U.S.?

(s) If you do have shared service centers or dedicated support functions, describe how these operations function and identify whose employees perform the service center and/or dedicated support functions.

11. Is there any service installation involved with the sale of your product?

(a) If yes, who performs this service? Please indicate whose employees/personnel perform the service and identify the location of the service personnel.

(b) Who schedules the installation?

(c) Who provides the installation services in the U.S.? Obtain Names/Addresses/Telephone #.

(d) Who schedules the installation in the U.S.? Obtain Names/Addresses/Telephone #.

(e) When did TP expand into the U.S.?

(f) How did TP initially market its product and/or services in the U.S.?

(g) Through whom did they market their product and/or services?

(h) Did TP enter into any marketing or distribution agreements for the U.S.? If yes, please provide a list of all such agreements and a copy of each agreement.

(i) How did they obtain their clients in the U.S.?

(j) How much has clientele expanded since TP expanded into the U.S.? Who would have info on the clients?

(k) How much has sales increased since expanding into the U.S.? Who would know this information?

(l) How does TP currently advertise its product and/or services?

(m) How are new customers obtained?

Continued on next page

General Background Information Questions for Foreign Corporation's Executive Officer or Local Operations Manager of U.S. Operation (continued)

(n) If salespeople are involved, how do they obtain new customers and what do they do to maintain current customers?

12. Description of the process by which the customer orders product or service through delivery of the product or service to customer's payment (i.e., how do the customer's payments flow back to the home office, how does client pay, where does client send the payment).
13. If a customer is not satisfied with the product and/or service, what procedure does the customer utilize to file a complaint?
14. Who does the customer first contact to initiate the complaint process when they are not happy with the product and/or service?
15. Determine who is responsible for managing the U.S. operations.
16. Obtain the Name(s) and Title(s) of these people.
    (a) Determine the names and titles of the people who held the positions during the audit years in question.
    (b) If they are not the people who held these positions during the audit years, find out where those people are now.
    (c) If the people who held the positions are not available, then determine who would have first-hand information regarding their positions and job responsibilities.
    (d) Determine if they report the results of U.S. operations back to the home office. If so, to whom do they provide the reports.
    (e) Determine what type of reports are prepared, specifically determine:
        1. What are the reports called?
        2. Who prepares them?
        3. In what format are they prepared?
        4. Where are they sent?
        5. Who reviews them?
        6. Secure copies of the reports AND have someone who is knowledgeable walk you through the report so that you have a good understanding of what is on the reports and how it is used.

Continued on next page

General Background Information Questions for Foreign Corporation's Executive Officer or Local Operations Manager of U.S. Operation (continued)

7. Where and by whom are these reports maintained?
8. How long are the reports maintained?

17. What type of documentation does this person maintain regarding the U.S. operations? Determine the purpose of each piece of documentation.
18. Where are the U.S. operation's books and records located? (**Note**: If at the home office, ask if a second set is maintained in the U.S.).
    (a) "WHO" (by name and title) maintains these books and records?
    (b) Secure a description of the books and records in sufficient detail, including names of journals, ledgers, types of invoices, bank accounts (locations and types), etc.
    (c) Determine if these records are maintained in machine readable format (electronic records).
    (d) Determine how long the records are maintained and, if they are stored, where are they stored and how the company can retrieve them if needed.

Questions for Sales manager and/or Sales Personnel

1. Name:
   Title:
   Education:
   Years of service with the company:
   How did you become employed here:
   Area covered:
2. How do you get leads to new clients?
3. Can you enter into and conclude a sales contract without further approval? If not, describe in detail the approval process for sales contracts.
4. Who does credit checks on perspective clients?
5. Who are you employed by?
   a) If independent, do you have a contract specifying duties, responsibilities, compensation, etc.? If you have a contract, please provide a copy of the contract.

Continued on next page

Questions for Sales manager and/or Sales Personnel (continued)

6. How are you compensated? Who issues your paycheck?
7. Describe your day-to-day responsibilities and duties:
   a) Where do you perform these duties?
   b) Are you provided with a desk and equipment at a specified location? If so, where are the desk and other equipment located? Do you have free access to the desk and other equipment?
   c) Do you perform any of your duties in the U.S.? Please identify the location(s) where you perform your duties in the U.S. and please state the percentage of time you spend at each location.
8. Reporting Process:
   a) Who do you report to?
   b) How do you report to this person?
   c) Is the reporting written or verbal?
   d) If written, what do you call these reports?
   e) How often do you prepare them?
   f) Where are they maintained?
   g) Do you have the reports for the period under examination?
9. How is a sales contract solicited, negotiated and concluded?
   a) Describe, in detail, each step of the transaction.
   b) Please identify by name and title any personnel from the foreign office with whom you have contact during this process.
   c) How often do you have contact with each of these persons and what is the nature of this contact?
   d) If you are an independent salesperson (not an employee of the foreign company) what other clients and products do you handle?

Continued on next page

Questions for Sales manager and/or Sales Personnel (continued)

e) Do you have an exclusive sales agreement with the foreign company? If so, please identify by name and title the person(s) who negotiated and signed that contract.

f) How often do you meet with someone from the company?

g) Where do these meetings take place?

h) Are there written notes, summaries, and minutes of these meetings? If so, please provide the name, title and location of the person who maintains these minutes.

Questions for Warehouse Personnel

1. Name:
   Title:
   Education:
   Years of service with the company:
2. How did you become employed here?
3. Description of day-to-day duties and responsibilities:
4. Who are you employed by:
   Name of immediate manager:
5. If independent, do you have an agreement?
6. Who owns the warehouse (i.e., who holds legal title, is it leased from someone, etc.)?
7. Who owns the inventory or products stored in the warehouse? Is there an agreement in your possession? If so, please provide a copy of that agreement.
8. Do you communicate with the company under examination? If so, how do you communicate and how often do you communicate with the company? Please identify the person with whom you communicate, by name and title.
9. What type of information do you exchange with each other? In what format is this exchange of information (i.e., facsimile, telephone, e-mail, etc.)?
10. What type of instructions do you receive from the company? Are you required to follow these instructions or do you have any discretion?

Continued on next page

Handout 2: *Permanent Establishment Interview Questionnaire*, Continued

Questions for Warehouse Personnel (continued)

11. Who is it that you communicate with? (Name and title)
    a) How often does that person visit your work location?
    b) What is the purpose of those visits?
    c) Is there a written summary or minutes or notes of the results of the visit and what was discussed? If so, where are those documents maintained? What are they called?
    d) Who determines stock levels and reorder points?
    e) How is shipping arranged and who coordinates the logistics?
    f) Who is responsible for insurance and risk on shipping?
    g) How is return and guarantee or warranty work handled?
    h) Who has final say in guarantee/warranty/decisions?

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International Technical Training

Chapter 14

Controlled Foreign Corporation (CFCs)

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 2 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and examples
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide

Overview

Instructor Notes

This chapter discusses what is considered a Controlled Foreign Corporation, or, CFC. After the lesson, the student should be prepared to learn the concept of Subpart F Income in the next chapter.

Introduction

Subpart F income will be discussed in depth in chapter 5. In order for Subpart F to apply to a U.S. shareholder of a foreign corporation, the foreign corporation must be a CFC. In this chapter, we will discuss the CFC, or controlled foreign corporation.

Objective

- At the end of this chapter, the student will be able to understand the CFC and be prepared to learn the relationship between the CFC and Subpart F Income.

Contents

This lesson covers the following topics:

Controlled Foreign Corporation (CFC)

Definition of CFC

IRC § 957(a)

A *foreign* corporation is a CFC for a particular year if on any day during such year U.S. shareholders own:

- more than 50 percent of the total combined voting power of all classes of the corporation's stock entitled to vote (voting test), or
- more than 50 percent of the total value of all classes of the corporation's stock (value test).

The term "U.S. shareholder" is discussed in chapter 5.

For purposes of determining whether a foreign corporation is a CFC, U.S. shareholders may own stock in the foreign corporation directly, indirectly, or constructively. Rules governing the determination of what constitutes direct, indirect, and constructive stock ownership in a CFC by U.S. shareholders are discussed in chapter 5.

Corporate Status Under U.S. Tax Law

In order for a foreign business entity to qualify as a CFC, it must be treated as a corporation for U.S. tax purposes. It is possible that a foreign business entity will not be treated as a corporate entity in the country in which it is created or organized. However, if such entity is classified as a corporation for U.S. tax purposes, the voting and value tests in IRC § 957(a) must be applied to determine whether it also qualifies as a CFC, notwithstanding the foreign classification.

Example 1

Treas. Reg. § 1.957-(1)(c) ex.(1)

Foreign corporation R has two classes of capital stock outstanding: 60 shares of class A stock and 40 shares of class B stock. Each share of each class of stock has one vote for all purposes. E, a U.S. person, owns 51 shares of class A stock. Corporation R is a CFC.

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Substantive Voting Control

Treas. Reg. § 1.957-1(b)

Treas. Reg. § 1.957-1(b) (1) requires that the voting power held by U.S. shareholders be determined by considering all facts and circumstances. This means that in determining whether a foreign corporation has the requisite stock ownership to qualify as a CFC, it is necessary to examine substantive voting power and not just the mere mechanical number of votes that a U.S. shareholder is entitled to cast. However, a foreign corporation will always qualify as a CFC if one or more of its U.S. shareholders have the power to do any of the following things:

- to elect, appoint or replace a majority of the board of directors (or of the corresponding governing group under local law);
- to elect exactly 1/2 of the members of the board of directors and either to break a deadlock of the board of directors, or during any such deadlock, to exercise managerial powers over the foreign corporation; or
- to elect the person who exercises the powers ordinarily exercised by the board of directors.

In addition, Treas. Reg. § 1.957-1(b)(2) provides that any arrangement to shift formal voting power away from U.S. shareholders will not be given effect if in reality voting power is retained. For example, if there is any agreement that a shareholder will not vote its stock or will vote its stock only in a specified manner, or that shareholders owning stock having 50 percent or less of the corporation’s total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power.

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Substantive Voting Control (continued)

Finally, Treas. Reg. § 1.957-1(b)(2) provides that where U.S. shareholders own shares of one or more classes of stock of a foreign corporation that has another class of stock outstanding, the voting power provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised if the following facts are present:

- the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights; and
- a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a CFC. Alternatively, if the voting power of the other class of stock is not exercised, such stock will be disregarded if the facts described in the preceding paragraph are present and the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the foreign corporation's earnings.

Value Test

- The Tax Reform Act of 1986 made the current definition of a CFC in IRC § 957(a) applicable to taxable years of foreign corporations beginning after December 31, 1986. Prior to that time, the definition of a CFC consisted solely of the voting test. Congress added the value test in order to prevent U.S. persons from disguising their control of foreign corporations by shifting exactly 50 percent of the voting control to foreign shareholders while retaining more than 50 percent of the value of the foreign corporation in the form of nonvoting stock.
- Note that the existence of the value test now renders unnecessary any determination of whether a U.S. shareholder owns more than 50 percent of a foreign corporation's voting stock if it can be more readily determined that the U.S. shareholder owns more than 50 percent of the foreign corporation's stock by value.

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Insurance CFCs

For purposes of determining whether a foreign corporation that receives insurance income (as defined in IRC § 953(a)) qualifies as a CFC, IRC § 953(c) (1) (B) reduces the stock ownership requirement for both the voting and value tests in IRC § 957(a) from “more than 50 percent” to “25 percent or more.”

Tax Planning

As a general rule, taxpayers try to prevent CFC status with respect to their foreign subsidiaries in order to avoid losing the benefit of tax deferral. However, taxpayers occasionally seek CFC status in order to obtain preferential treatment under the foreign tax credit rules of IRC §§ 902 and 960.

Example 2

Treas. Reg. § 1.957-1(c) ex. (7)

Foreign corporation A is authorized to issue 100 shares of one class of capital stock. A issues, for $1,000 per share, 45 shares to domestic corporation M, 45 shares to foreign corporation B, and 10 shares to foreign corporation C. Corporation C, a bank, lends $3 million to finance the operations of A corporation. In the course of negotiating these financial arrangements, D, an officer of C corporation, and E, an officer of M corporation, orally agree that C corporation will vote its stock as M corporation directs. By virtue of such oral arrangement, M corporation possesses the voting power ostensibly owned by C corporation. A is therefore a CFC.

International Technical Training

Chapter 15

Passive Foreign Investment Companies

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide • Participant Guide
Participant Materials	• Participant Guide • Pencils/Pens • Highlighters
Participant References	• IRC §§ 1291, 1293 through 1297, and 1298 • Proposed Treas. Reg. §§ 1.1291-1 through 1.1291-6, and 1.1291-8 • Treas. Reg. §§ 1.1293-1,1.1295-1, 1.1296-1 & 2
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides prepared by Instructor • Flipcharts and markers • Transparency markers • Overhead projector

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Instructor Information, Continued

Instructor Notes

Display and state the *Objectives*. May use flipcharts, transparency, and Power Point slides.

Overview

Introduction

The Tax Reform Act of 1986, as amended by the Technical and Miscellaneous Revenue Act of 1988, established special rules for the taxation of U.S. persons that are shareholders of passive foreign investment companies (PFICs).

For taxable years beginning after December 31, 1986, a foreign corporation will be classified as a PFIC if either 75 percent or more of its gross income for the taxable year is passive, or the average percentage of its assets for the taxable year that produce passive income or are held for the production of passive income is at least 50 percent.

Subject to certain exceptions, passive income for these purposes generally is foreign personal holding company income as defined in IRC § 954(c).

Market to Market Election

§1122(a) of the Taxpayer Relief Act of 1997 amends Part VI of subchapter P of chapter 1 by renumbering IRC §§ 1296 and 1297 to IRC §§ 1297 and 1298, respectively. IRC § 1296 was reinserted as “Election Of Market To Market For Marketable Stock."

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Lesson Summary

This lesson will cover the two criteria for determining if a foreign corporation qualifies as a passive foreign investment company (PFIC) as defined under IRC § 1297. This lesson also outlines the two alternative sets of income inclusion rules that apply to U.S. persons that are shareholders in a PFIC.

One set of rules applies to PFICs that are qualified electing funds **(QEF)**, under which electing U.S. shareholders include currently in gross income their respective shares of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.

The **second set of rules** applies to PFICs that are not QEFs (nonqualified funds), under which the U.S. shareholders pay tax on income realized from the PFIC and an interest charge that is attributable to the value of deferral.

Market to Market Election was made available under IRC §1296. This lesson discusses how the election affects the PHIC both in terms of current taxation and basis adjustments to the stock.

Lesson Objective

At the end of this lesson, you will be able to:

- Identify a passive foreign investment company (PFIC).
- Determine the tax consequences, if any, to a U.S. person owning stock in a PFIC.

References

- IRC §§ 1291, 1293 through 1297, and 1298
- Proposed Treas. Reg. §§ 1.1291-1 through 1.1291-6, and 1.1291-8
- Treas. Reg. §§ 1.1293-1, 1.1295-1, 1.1296-1 & 2

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Contents

This lesson covers the following topics:

What is a Passive Foreign Investment Company

General Rule

IRC § 1297(a) defines a passive foreign investment company (PFIC) as any foreign corporation if:

1. 75 percent or more of its gross income for the tax year consists of passive income, or
2. 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of passive income.

Reading Assignment

Read IRC §1297(a).

Amendments and Effective Dates

- Prior to January 1, 1998, **IRC § 1297 was IRC § 1296.**
- Taxpayer Relief Act of 1997 amends subsection (a)(2) by striking (**by value**) and inserting (**as determined in accordance with subsection (e)**, effective for taxable years beginning after December 31, 1997.
- 1993 AMENDMENT added the last paragraph to subsection (a) and is applicable to taxable years of foreign corporations beginning after September 30, 1993.

Continued on next page

What is a Passive Foreign Investment Company, Continued

Exceptions

- A newly organized corporation is given a one-year (start-up year) reprieve if it meets the passive income or asset test in the first year it has gross income, provided that it is not a PFIC in either of the two following years.
- For years after 1997, IRC § 1297(e) generally treats a PFIC that is also a CFC as not being a PFIC with respect to certain 10 percent shareholders. This rule applies if the corporation is a CFC under the IRC § 957(a) and the shareholder is an U.S. shareholder (under IRC § 951(b)) of the corporation (that is, if the shareholder is subject to the current inclusion rules of Subpart F).

Reading Assignment

IRC §§ 1297(e) and 1298(b)(2).

Passive Income

General Rule

Passive income includes dividends, interest, passive rents and royalties, net gains on sales of property producing passive income, and other income classified as foreign personal holding company income for purposes of Subpart F.

However, it excludes income earned in the active conduct of a banking business, income derived in the active conduct of a securities business, and insurance income of a corporation predominantly engaged in an insurance business.

Reading Assignment

IRC §§ 1297(b) and 954(c).

Amendments and Effective Dates

The Taxpayer Relief Act of 1997 repeals paragraph (3) of IRC § 1297(b).

The security dealer exception is now contained in IRC § 954(c) (2) (C) as an exclusion from FPHC.

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Exceptions

The PFIC definition of passive income generally conforms to the definition of passive income under Subpart F (IRC § 954(c)). However, under the exceptions provided by IRC § 1297(b)(2), **passive income does not include:**

- Income derived in the active conduct of a banking business by a licensed bank;
- Income derived in the active conduct of an insurance business by a corporation predominately engaged in an insurance business and which would be an insurance company if it were a domestic company;
- Interest, dividend, or rent or royalty income that is received or accrued from a related person to the extent the amount is allocable to non-passive income of the related person;
- Income that is export trade income of an export trade corporation; or
- As provided by IRC § 954(h) - foreign personal holding company income shall not include qualified banking or financing income of an eligible controlled foreign corporation, but only if the corporation is predominantly engaged in the active conduct of such business.

Passive Income and Asset Tests

Look-Through Rules

In order to determine whether a foreign corporation is a PFIC, the look through rule mandates that income and assets of the foreign corporation's subsidiaries are included when performing the income and asset tests.

There are **two look-through rules.**

- The look-through rule under IRC § 1297(c) is applied when a foreign corporation is the direct or constructive owner of at least 25 percent (by value) of the stock of another corporation. This look through rule is provided so those foreign corporations that own subsidiaries primarily engaged in active business operations are not treated as PFICs. The passive income and asset tests are applied by including the ratable share of the subsidiary's income and assets as that of the foreign corporation.
- Another look-through rule in IRC § 1297(b) (2) (C) applies to interest, dividends, rents, and royalties from related persons who control or are controlled by a foreign corporation. The rule allocates income and excepts such income from the definition of passive to the extent it is allocable to active income of the payor.

Reading Assignment

IRC §§ 1297(b) and 954(c).

Continued on next page

Example 1

If a foreign corporation’s only assets are stock and debt instruments of operating subsidiaries, which only received non-passive income, and the corporation’s only income is dividends and interest from the subsidiaries, the corporation is not a PFIC because:

- Its income is deemed to consist of the non-passive income of the subsidiaries, not the dividends and interest actually received from the subsidiaries, and
- Its assets are deemed to consist of the operating assets of the subsidiaries, not the stock and debt instruments it actually owns.

Example 2

An operating foreign corporation, with no passive income or assets, is sole shareholder of a foreign subsidiary whose assets are all portfolio investments. The operating corporation is treated as owner of the assets of the investment corporation, and these assets and income produced are included in applying the passive income and asset tests.

- If the deemed held assets account for at least 50 percent of all assets, the operating company is a PFIC, or
- If at least 75 percent of the operating corporation’s deemed gross income (including the subsidiary’s gross passive income) is passive income, the operating corporation is a PFIC.

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Methods for Measuring Assets

Prior to the Taxpayer Relief Act of 1997, foreign corporations that were not controlled foreign corporations utilized the value of its assets as measurement for the passive asset test if the adjusted basis of its assets was not elected by the taxpayer. Controlled foreign corporations were mandated to use the adjusted basis of its assets for measurement.

For taxable years after December 31,1997, IRC § 1297(e) measures assets:

- based on the value of the assets of a foreign corporation if the corporation is a publicly traded corporation for the taxable year, or
- based on the value of the assets of a non-publicly traded foreign corporation if:
  the foreign corporation is not a controlled foreign corporation, and the foreign corporation did not elect to use the adjusted basis method, or
- based on the adjusted basis of the assets of a controlled foreign corporation that is not a publicly traded corporation, or
- based on the adjusted basis if a not publicly traded foreign corporation elects to measure its assets accordingly. **Once the election is made, it may be revoked only with the consent of the Secretary.**

Reading Assignment

IRC §§ 1297(b) and 954(c).

Taxation of Shareholder

IRC § 1291 Fund

In general, shareholders are subject to a special tax regime under IRC § 1291 that applies to distributions by the PFIC and dispositions of PFIC stock. In the proposed regulations, if IRC § 1291 applies to a particular shareholder, the PFIC is referred to as an IRC § 1291 fund with respect to the shareholder. **A significant consequence of being treated as an IRC § 1291** fund is that the foreign corporation will continue to be treated as a PFIC, even after the corporation ceases to satisfy either the income or the asset test for PFIC status under IRC § 1297. This is referred to as the **"once a PFIC, always a PFIC" rule.**

Qualified Electing Fund (QEF)

Each shareholder may elect under IRC § 1295 to treat a PFIC as a qualified electing fund (QEF), in which case the shareholder will be taxed currently on its pro-rata share of ordinary earnings and not capital gain. **A shareholder in a QEF can elect under IRC § 1294 to defer payment of tax, subject to an interest charge.** If a shareholder makes the QEF election in the corporation's first tax year as a PFIC that is included in the shareholder's holding period for the stock, **IRC § 1291 does not apply to that shareholder.** If the QEF election is made at a later time and the shareholder elects under IRC § 1291(d) (2) to "purge the PFIC stock of its taint as an IRC § 1291 fund," IRC § 1291 will not later apply to that shareholder. The proposed regulations refer to this type of PFIC as a **"pedigreed QEF"** regarding the electing shareholder. In general, IRC § 1291 and the proposed regulations under that section do not apply to determine the taxation of a shareholder of a pedigreed QEF with respect to a distribution paid by the pedigreed QEF or a disposition of its stock.

Definitions

- A **Qualified Electing Fund (QEF)** is a PFIC with respect to a shareholder that has elected under IRC § 1295 to be taxed currently on its share of earnings and profits pursuant to IRC § 1293.
- A **PEDIGREED QEF** is a PFIC with respect to a shareholder that has been a QEF with respect to the shareholder for all taxable years that are included wholly or partly in the shareholder's holding period of the PFIC stock and during which the corporation was a PFIC.

Continued on next page

Definitions (continued)

- An **UNPEDIGREED QEF** is a PFIC for a taxable year if --
  - (A) An election under IRC § 1295 is in effect for that year;
  - (B) The PFIC has been a QEF with respect to the shareholder for at least one, but not all, of the taxable years that are included wholly or partly in the shareholder's holding period of the PFIC stock and during which the corporation was a PFIC; and
  - (C) The shareholder has not made an election under IRC § 1291(d)(2) and Treas. Reg. § 1.1291-9 or 1.1291-10 with respect to the PFIC to purge the prior PFIC years from the shareholder's holding period.
- A **NONQUALIFIED FUND** is a PFIC with respect to which a shareholder has not elected under IRC § 1295 to treat the PFIC as a QEF.
- An **IRC § 1291 FUND** is an unpedigreed QEF or a nonqualified fund.

Reading Assignment

- Treas. Reg. § 1.1291-1(a)
- Treas. Reg. § 1.1291-1(b) Definitions
- Treas. Reg. § § 1.1291-1(b)(2)(v) & (2)(iii) & (iv)
- Proposed Treas. Reg. § 1.1291-1(b)(1)(ii)
- IRC §§ 1293, 1295 and 1291(d)(2)
- Treas. Regs. §§ 1.1291-10 and 1.1291-9

Taxation of an IRC § 1291 Fund

Taxation

Now that you are able to determine the PFICs that qualify as an IRC § 1291 fund, we will review the rules for taxing a direct or indirect shareholder of an IRC § 1291 fund.

Pursuant to IRC § 1291**, a U.S. person** that is a shareholder of an IRC § 1291 fund pays tax and an interest charge on receipt of certain distributions and upon disposition of stock of the IRC § 1291 fund. Under this rule, gain from a disposition or the portion of any distribution that is an excess distribution (defined in IRC § 1291(b)) is treated as ordinary income earned ratably over the shareholder's holding period of the stock of the IRC § 1291 fund.

The portions allocated to the current year and to years when the corporation was not a PFIC are included in the shareholder's gross income for the year of the distribution. The remainder is not included in gross income, but the shareholder must pay a deferred tax amount (defined in IRC § 1291(c)) with respect to that portion. The deferred tax amount is, in general, the amount of tax that would have been owed if the allocated amount had been included in income in the earlier year, plus interest.

Excess Distribution

Per IRC § 1291(b), “excess distribution” means any distribution in respect of stock received during any taxable year to the extent such distribution does not exceed its ratable portion of the total excess distribution (if any) for such taxable year. While IRC § 1291(b)(2) defines the term "total excess distribution" as the excess (if any) of—

(i) The amount of the distributions in respect of the stock received by the taxpayer during the taxable year, over
(ii) 125 percent of the average amount received in respect of such stock by the taxpayer during the three proceeding taxable years (or, if shorter, the portion of the taxpayer's holding period before the taxable year).

Non-excess Distribution

A non-excess distribution is taxable to the shareholder according to the general rules of taxation applicable to distributions made by a corporation to a shareholder with respect to its stock.

Continued on next page

Reading Assignment

- IRC § 1291(b)
- Proposed Treas. Reg. §§ 1.1291-2(c)(1) and 1.1291-2(c)(2)(i).

Taxation of a Distribution and Effect on Earnings & Profits

In General

To determine the taxation of an excess distribution, the excess distribution is first allocated pro rata to each day in the shareholder's holding period **(as determined under Treas. Reg. § 1.1291-1(h))** of the share of stock with respect to which the distribution was made. The holding period of a share of stock of an IRC § 1291 fund is treated as ending on (and including) the date of each excess distribution solely for purposes of allocating the excess distribution.

Example 1

FACTS. X, a U.S. person, purchased a share of stock of FC, a foreign corporation, on December 31, 1993. FC has been an IRC § 1291 fund since its taxable year that began January 1, 1995. X received distributions from FC of $50 on December 31, 1995, $80 on December 31, 1996, and $150 on December 31, 1997. FC made no distributions in 1994.

1995 EXCESS DISTRIBUTION. Because X did not receive a distribution from FC during 1994, the total distribution of $50 is the total excess distribution for 1995. That amount is allocated pro rata over X's two-year holding period, as provided in Treas. Reg. § 1.1291-2(e) (2) (i): $25 is allocated to 1994, a pre-PFIC year, and $25 to 1995, the current shareholder year. The entire **$50**, therefore, is included in X's gross income for 1995 as ordinary income.

1996 EXCESS DISTRIBUTION. In 1996, of the $80 total distribution, $31.25 [125% times $25 [(0 + $50) / 2]] is the non-excess distribution, and is taxable as a corporate distribution as provided in IRC § 301(c). The total excess distribution for 1996, $48.75 ($80 - $31.25), is allocated over X's three-year holding period; $16.25 is allocated to each year.

The portions of the excess distribution allocated to the pre PFIC year (1994) and the current shareholder year (1996) total $32.50; that amount is included in X's gross income as ordinary income. The $16.25 portion of the excess distribution allocated to 1995, the prior PFIC year, is not included in X's gross income, but is subject to the deferred tax amount. Of the $80 distribution, *$63.75* ($31.25 + $32.50) is included in X's gross income in 1996.

Continued on next page

Example 1 (continued)

1997 EXCESS DISTRIBUTION. In 1997, of the $150 total distribution, $47.40 [125% times $37.90 [(0 + $50 + $63.75*) / 3]] is the non-excess distribution, and is taxable as a corporate distribution as provided in IRC § 301(c). The total excess distribution for 1997, $102.60 ($150 - $47.40), is allocated over X's four-year holding period; $25.65 is allocated to each year.

The portions of the excess distribution allocated to the pre-PFIC year (1994) and the current shareholder year (1997) total $51.30; that amount is included in X's gross income as ordinary income. The portions of the excess distribution allocated to the prior PFIC years (1995 and 1996) total $51.30; that amount is not included in X's gross income but is subject to the deferred tax amount. Of the total $150 distribution, $98.70 ($47.40 + $51.30) is included in X's gross income in 1997.

* **Note**: The portion of excess distribution not included in gross income ($16.25) is not included in calculation of non-excess distribution.

Example 2

FACTS. X, a U.S. person with a calendar taxable year, purchased 1,000 shares of stock of FC, a corporation, on December 31, 1990. FC has been a § 1291 fund since its taxable year that began January 1, 1992. FC distributed $100,000 to X on January 31, 1994, and $200,000 to X on July 31, 1994. X determined the total excess distribution for 1994 to be $150,000.

JANUARY 31 DISTRIBUTION. The excess distribution allocated to the January 31 distribution, which is the ratable portion of the total excess distribution allocated to the $100,000 distribution made on that date, is $50,000 [$150,000 x ($100,000 / $300,000)].

Continued on next page

Example 2 (continued)

For purposes of allocating the $50,000 excess distribution over X's holding period, X's holding period is treated as ending on (and including) January 31, 1994. X thus held the stock for 1,127 days (365 days in both 1991and 1993, 366 days in 1992, and 31 days in 1994) at the time of the January 31 distribution. The $50,000 excess distribution allocated to the January 31 distribution is allocated pro rata to the 1,127 days; approximately $44.37 is allocated to each day in the holding period. The total allocations to each of the taxable years in X's holding period are as follows:

TAXABLE YEAR	TOTAL ALLOCATION PER YEAR
1991	$16,193.70
1992	$16,237.70
1993	$16,193.70
1994	$ 1,374.90
Excess distribution	$50,000.00

The allocation to 1991, the pre-PFIC year, the allocation to 1994, and the current shareholder year are included in X's gross income for 1994, as ordinary income. The allocations to 1992, 1993, and the prior PFIC years are not included in X's gross income in 1994, but are subject to the deferred tax amount.

JULY 31 DISTRIBUTION. The excess distribution allocated to the July 31 distribution, which is the ratable portion of the total excess distribution allocated to the distribution made on that date, is $100,000 [$150,000 x ($200,000/$300,000)].

For purposes of the allocation of this excess distribution, X's holding period is treated as ending on July 31, 1994. X thus held the stock for 1,308 days (365 days in both 1991 and 1993, 366 days in 1992, and 212 days in 1994) at the time of the July 31 distribution.

Continued on next page

Example 2 (continued)

The $100,000 excess distribution allocated to the July 31 excess distribution is allocated pro rata to the 1,308 days; approximately $76.45 is allocated to each day in the holding period. The total allocations of the July 31 excess distribution to each of the taxable years in X's holding period are as follows:

TAXABLE YEAR	TOTAL ALLOCATION PER YEAR
1991	$27,905.20
1992	$27,981.65
1993	$27,905.20
1994	$16,207.95
Excess distribution	$100,000

The portions of the excess distribution allocated to 1991, the pre-PFIC year, and to 1994, the current shareholder year is included, as ordinary income in X's gross income for 1994.

The portions of the excess distribution allocated to 1992 and 1993, the prior PFIC years are not included in X's gross income in 1994, but are subject to the deferred tax amount.

Example 3

FACTS. X, a U.S. person, holds six shares of the stock of FC, an IRC § 1291 fund. Two shares were purchased on December 31, 1991 (Block #1), and four shares were purchased on December 31, 1992 (Block #2).

On June 30, 1992 and 1993, FC distributed $10,000 in respect of each outstanding share of its stock. No portion of the distributions in either year was an excess distribution. On June 30, 1994, FC distributed $30,000 in respect of each outstanding share of its stock.

Continued on next page

Example 3 (continued)

CALCULATION OF THE 1994 EXCESS DISTRIBUTIONS. The excess distribution is determined separately for each block of stock.

(A) BLOCK #1 EXCESS DISTRIBUTION. The non-excess distribution for Block #1 is $25,000 [125% times [($20,000 + $20,000) / 2]. The total excess distribution for Block #1 is $35,000 ($60,000 - $25,000).

(B) BLOCK #2 EXCESS DISTRIBUTION. The non-excess distribution for Block #2 is $50,000 [125% times $40,000 (the distribution received in the only preceding taxable year included in X's (12/31/92) holding period). The total excess distribution for Block #2 is $70,000 ($120,000 - $50,000).

BLOCK #1 ALLOCATION. The holding period of the Block #1 stock began on January 1, 1992, and ended for purposes of IRC § 1291, on June 30, 1994, for a total of 912 days (365 days in 1993, 366 days in 1992 and 181 days in 1994). The $35,000 excess distribution for Block #1 is allocated pro rata to each of the 912 days. Accordingly, approximately $38.38 is allocated to each day. The total allocations to each of the taxable years in X's holding period are as follows:

TAXABLE YEAR	TOTAL ALLOCATION PER YEAR
1992	$14,046.10
1993	$14,007.70
1994	$ 6,946.20
1995	
Excess distribution	$35,000

The portion of the excess distribution allocated to 1994, the current shareholder year, of $6,946.20, is included, as ordinary income in X's gross income for 1994. The portions of the excess distribution allocated to the prior PFIC years, 1992 and 1993, an aggregate of $28,053.80, are not included in X's gross income in 1994, but are subject to the deferred tax amount.

Continued on next page

Example 3 (continued)

BLOCK #2 ALLOCATIONS.
The holding period of the Block #2 stock began on January 1, 1993, and ended for purposes of IRC § 1291, on June 30, 1994, for a total of 546 days (365 days in 1993 and 181 days in 1994).

The excess distribution of $70,000 in respect of the Block #2 stock is allocated pro rata to each of the 546 days. Accordingly, approximately $127.97 is allocated to each day. The total allocations to each of the taxable years in X's holding period are as follows:

TAXABLE YEAR	TOTAL ALLOCATION PER YEAR
1993	$46,837.40
1994	$23,162.60
Excess distribution	$70,000

The portion of the excess distribution allocated to 1994, the current shareholder year, of $23,162.60, is included as ordinary income in X's gross income for 1994. The portion of the excess distribution allocated to 1993, $46,837.40, is not included in X's gross income in 1994, per 1291(b) (2) (B) –"No excess for 1st year," but is subject to the deferred tax amount.

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Allocation of E&P among Non-Excess and Excess Distributions

Example 4

X is a U.S. person that owns all the stock of FC, an IRC § 1291 fund. At the end of its 1991 taxable year, FC has accumulated earnings and profits, before reduction for distributions made during the year of $100, none of which was previously taxed to X under IRC § 951 or 1293. FC distributes $200 to X on the last day of FC's taxable year.

X determines that, of the $200 distribution, $50 is a non-excess distribution, and $150 is the total excess distribution. FC's earnings and profits of $100 are allocated proportionately between the non-excess distribution of $50 and the excess distribution of $150, and reduced to zero. Accordingly, $25 of FC's earnings and profits is allocated to the non-excess distribution and $75 of FC's earnings and profits are allocated to the excess distribution.

Therefore, $25 of the $50 non-excess distribution is taxable as a dividend under IRC § 301(c)(1), and the remaining $25 is taxable to the extent provided in IRC § 301(c)(2) and (3). The excess distribution of $150 is taxable as provided in
Treas. Reg. § 1.1291-2(e) (2).

Disposition of Stock of an IRC § 1291 Fund

In General

Any direct or indirect disposition of stock of an IRC § 1291 fund is taxable to the extent provided in IRC § 1291. Gain is determined on a share-by- share basis and is taxed as an excess distribution as provided in Treas. Reg. § 1.1291-2(e) (2). Unless otherwise provided under another provision of the Code, a loss realized on a disposition of stock of an IRC § 1291 fund is not recognized.

A disposition is any transaction or event that constitutes an actual or deemed transfer of property including (but not limited to) a sale, exchange, gift, or transfer at death, an exchange pursuant to a liquidation or IRC § 302(a) redemption, or a distribution described in IRC §§ 311, 336, 337, 355(c) or 361(c).

Indirect Disposition

An indirect disposition is --

- Any disposition of stock of an IRC § 1291 fund by its actual owner if such stock is attributed to an indirect shareholder under Treas. Reg. § 1.1291-1(b) (8);
- Any disposition, by an indirect shareholder or any other person, of any interest in a person, if by virtue of such interest the indirect shareholder was treated as owning stock of an IRC § 1291 fund under Treas. Reg. § 1.1291-1(b) (8); or
- Any other transaction as a result of which an indirect shareholder's ownership of an IRC § 1291 fund is reduced or terminated.

Reading Assignment

- Proposed Treas. Reg. § 1.1291-3 and 1.1291-1(b)(8)
- IRC §§ 1291(a)(2) and 1291(f)

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Example 1

T, a U.S. person, and M, a foreign person, are equal partners of FP, a foreign partnership that owns 10 shares of stock of FC, a PFIC. Pursuant to Treas. Reg. § 1.1291-1(b) (8) (iii), T is an indirect shareholder of one-half of the shares of FC stock held by FP. T did not elect under IRC § 1295 to treat FC as a QEF. On August 14, 1994, H, a U.S. person, joins the partnership as an equal partner. As a result of H's acquisition of one-third of FP, H is an indirect shareholder of one-third of the FC stock held by FP. H's acquisition of the FP interest is a disposition pursuant to Treas. Reg. § 1.1291-3(e) (2) (iii), taxable to T, of one-third of T's interest in the FC stock.

Example 2

E, a U.S. person, and R, a foreign person, each owns 50 percent of the outstanding stock of Distributing, a foreign corporation that is not a PFIC or a controlled foreign corporation within the meaning of IRC § 957(a). Distributing owns all the stock of Controlled, a PFIC. E is an indirect shareholder of Controlled. E did not elect under IRC § 1295 to treat Controlled as a QEF. In a transaction that qualifies under IRC § 355(a), Distributing distributes all the Controlled stock to R. As a result of the distribution, E's interest in Controlled is terminated. The distribution is an indirect disposition of E's ownership of Controlled, within the meaning of Treas. Reg. § 1.1291-3(e) (2) (i), taxable to E under Treas. Reg. § 1.1291- 3(e).

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Example 3

C, a U.S. person, owns 51 percent of the stock of CFC, a foreign corporation that is not a PFIC. Several foreign persons own the remaining 49 percent of CFC. CFC owns 100 shares of FYZ, a PFIC. C is an indirect shareholder of 51 shares of the FYZ stock held by CFC. C did not elect under IRC § 1295 to treat FYZ as a QEF. To raise capital, CFC makes a public offering of its stock. After the offering, C owns only 35 percent of the CFC stock. The reduction of C's ownership of CFC terminated C's indirect ownership of the FYZ stock and, therefore, is an indirect disposition of the FYZ stock, pursuant to Treas. Reg. § 1.1291-3(e)(2)(iii), taxable to C under Treas. Reg. § 1.1291-3(e).

Reading Assignment

Proposed Treas. Reg. § 1.1291-3(e).

Taxes and Interest on Excess Distributions and Recognized Gains

In General

The deferred tax amount is the sum of the aggregate increases in taxes and the aggregate amount of interest determined with respect to the aggregate increases in taxes. The deferred tax amount is computed for the portions of each excess distribution allocated to different prior PFIC years, as defined in IRC § 1291(c).

The aggregate increases in taxes are an additional amount of tax imposed on the shareholder for the current shareholder year. The aggregate amount of interest is treated as interest under IRC § 6601. For the prior PFIC year for which the net increase in tax was computed and ending on the due date for the income tax return for the current shareholder year (that is, the year of the distribution), the term due date means the date prescribed by law determined without regard to extensions for filing the income tax return for the taxable year of the shareholder.

Increase in Tax

An increase in tax is determined for each portion of an excess distribution allocated to a prior PFIC year. Each increase in tax is determined by multiplying the amount of the excess distribution allocated to the prior PFIC year by the highest statutory rate of tax in effect under either IRC § 1 or IRC § 11, as applicable, for that prior PFIC year.

Rate of Tax in Effect

The highest statutory rate of tax is determined without regard to the actual rate of tax to which the shareholder was subject in that prior PFIC year. The rate of tax in effect in the case of a distribution or disposition taxable to an indirect shareholder is the rate in effect for the indirect shareholder.

For taxable years of the shareholder beginning after 1987 and before January 1, 1991, the highest statutory rate of tax in effect under IRC § 1 is 28 percent. If there was a change of tax rates during a taxable year, the highest rate of tax is determined in the manner described in IRC § 15(e) using the highest statutory rates of tax in effect before and after the change of rates.

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Reduction for Foreign Taxes

To the extent provided in IRC § 1291(g) and Proposed Treas. Reg. § 1.1291-5, each increase in tax is reduced by the foreign tax credit calculated with respect to the increase in tax.

Reading Assignment

- IRC §§ 1291(a) (1) (C), 1291(c) and 1291(g)
- Proposed Treas. Regulations §§1.1291-4 and 1.1291-5

Example 1

FACTS. X is a domestic corporation that is a calendar year taxpayer. The due date (without regard to extensions) for its federal income tax return is March 15. X acquired a share of stock of FC, a corporation, on December 31, 1986, for $500. FC has been an IRC § 1291 fund with respect to X since FC's taxable year that began January 1, 1987. On December 31, 1990, X sold the FC stock for $1000. X did not incur any foreign tax on the disposition of the FC stock. X's gain on the sale, $500, is taxed as an excess distribution. The excess distribution is allocated pro rata over Ks four-year holding period. Accordingly, $125 is allocated to each year in X's holding period. The $125 allocated to 1990, the current shareholder year, is included in X's ordinary income for that year. The allocations to 1987, 1988, and 1989, the prior PFIC years, are subject to the deferred tax amount under Treas. Reg. § 1.1291-4.

CALCULATION OF THE 1987 INCREASE IN TAX. The increase in tax for the $125 allocated to 1987 is determined in the manner described in IRC § 15(e) by using a weighted average rate. The weighted average rate is 40 percent:

46% rate:	181/365 x 46% =	22.81%
34% rate:	184/365 x 34% =	17.14%

		39.95%

The increase in tax for 1987 is $49.94 ($125 x 39.95%).

Continued on next page

Example 1 (continued)

CALCULATION OF THE OTHER INCREASES IN TAX. The highest statutory rate of tax applicable to X that was in effect for both 1988 and 1989 was 34 percent. The increase in tax for each of 1988 and 1989 is $42.50 ($125 x 34%).

AGGREGATE INCREASES IN TAXES. The aggregate increases in taxes are $134.94 ($49.94 + $42.50 + $42.50).

INTEREST CHARGE. Interest on each of the three increases in tax ($49.94, $42.50, and $42.50) is computed using the rates and method provided in IRC § 6621 for the respective interest period. The following are the interest periods:

YEAR OF ALLOCATION	INCREASE IN TAX	INTEREST PERIOD	
		BEGINNING ON	ENDING ON
1987	$49.94	March 15, 1988	March 15, 1991
1988	42.50	March 15, 1989	March 15, 1991
1989	42.50	March 15, 1990	March 15, 1991

Example 2

FACTS. The facts are the same as in EXAMPLE 1 except that X was a C corporation until it elected to be treated as an S corporation effective for its taxable year beginning January 1, 1988.

A is a U.S. person who has been a shareholder of X since January 1, 1988. A's holding period of the FC stock began on January 1, 1988, pursuant to Treas. Reg. § 1.1291-1(h) (4) (i). As of January 1, 1988, the FC stock had appreciated in value to $800; X, therefore, had $300 of built-in gain within the meaning of IRC § 1374. Assume X pays a built-in gain tax of $102 because of the sale of the FC stock in 1990.

Continued on next page

Example 2 (continued)

1. **CALCULATION OF THE AGGREGATE INCREASES IN TAXES OWED BY A**.
   The $500 gain recognized, reduced as provided in IRC § 1366(f) (2) by the amount of built-in gain tax of $102 paid by X pursuant to IRC § 1374 to $398, is taxable to A as an excess distribution as provided in Treas. Reg. § 1.1291-2(e)(2). The $398 excess distribution is allocated pro rata over X's four-year holding period (not A's three-year holding period) as provided in Treas. Reg. § 1.1291-3(e) (5).

   The allocation of $99.50 to 1990, the current shareholder year, is included in A's ordinary income. The allocations of $99.50 to 1987, 1988, and 1989 are not included in income but are subject to the deferred tax amount. The aggregate increases in taxes are determined based on those $99.50 allocations.

2. **CALCULATION OF THE 1987 INCREASE IN TAX**. The highest statutory rate of tax applicable to A that was in effect in 1987 was 38.5 percent. The increase in tax for the portion of the excess distribution allocated to 1987 is $38.31 ($99.50 x 38.5%).
3. **CALCULATION OF THE OTHER INCREASES IN TAX**. The highest statutory rate of tax applicable to A that was in effect for both 1988 and 1989 is 28 percent. The increase in tax for each of 1988 and 1989 is $27.86 ($99.50 x 28%).
4. **CALCULATION OF THE AGGREGATE INCREASES IN TAXES.** The aggregate increases in taxes are $94.03 ($38.31 + 27.86 + 27.86).
5. **CALCULATION OF THE AGGREGATE AMOUNT OF INTEREST**.
   For purposes of calculating the aggregate amount of interest, the reduction provided under IRC § 1366(f)(2) is disregarded and the excess distribution is $500. Accordingly, for purposes of calculating the aggregate amount of interest, $125 is allocated to 1987, 1988, and 1989.

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6. **CALCULATION OF THE 1987 HYPOTHETICAL INCREASE IN TAX.**
   The highest statutory rate of tax applicable to A that was in effect in 1987 was 38.5 percent. The hypothetical increase in tax for the portion of the excess distribution allocated to 1987 is $48.12 ($125 x 38.5%).
7. **CALCULATION OF THE OTHER HYPOTHETICAL INCREASES IN TAX.**
   The highest statutory rate of tax applicable to A that was in effect for both 1988 and 1989 is 28 percent. The hypothetical increase in tax for each of 1988 and 1989 is $35.00 ($125 x 28%).
8. **INTEREST CHARGE.**
   Interest on each of the three hypothetical increases in tax ($48.12, $35, and $35) is computed using the rates and method provided in IRC § 6621 for the respective interest period. The following are the interest periods:

YEAR OF ALLOCATION	INCREASE IN TAX	INTEREST PERIOD	
		BEGINNING ON	ENDING ON
1987	$49.94	March 15, 1988	March 15, 1991
1988	42.50	March 15, 1989	March 15, 1991
1989	42.50	March 15, 1990	March 15, 1991

THE DEFERRED TAX AMOUNT.
The deferred tax amount is the sum of the aggregate increases in taxes determined in (1) and the aggregate amount of interest determined in (8).

Coordination with the Foreign Tax Credit Rules

In General

Initially, IRC § 1291 had a harsh impact on the use of indirect foreign tax credits under IRC § 901. A domestic corporation owning 10 percent or more of the voting stock of a foreign corporation could lose the right to use indirect foreign tax credits if the foreign corporation was a PFIC. However, in 1988, Congress added IRC § 1291(g) to handle foreign tax credits; and in 1992, the Proposed Treas. Regs. (§ 1.1291-5) provided steps to determine the foreign tax credit a shareholder may claim against the increases in tax on an excess distribution, including in certain cases the excess distribution on a disposition of stock of an IRC § 1291 fund.

Reading Assignment

- IRC § 1291(g)
- Proposed Treas. Regulations § 1.1291-5

Market to Market Election Under §1296

General Rule

A PFIC investor who owns “marketable” stock in a PFIC is eligible to make an election to be taxed under the “mark-to-market” rules of IRC §1296 which effectively provide for current taxation (at ordinary income rates) of appreciation in value of his or her PFIC stock. This may prove advantageous where the investor cannot make the QEF election (because the PFIC does not provide the requisite information to make the election), or prefers not to make the QEF election but does not wish to be exposed to the excess distribution rules. This election may not be made with respect to PFIC stock owned through a foreign corporation that is not otherwise a CFC. Consequently, the election may not be made with respect to stock in a PFIC (“second-tier PFIC”) that is owned by an intermediate PFIC (“first-tier PFIC”), regardless of whether a “mark-to-market” election has been made with respect to the first-tier PFIC. The only options for the indirect U.S. investor in a second-tier PFIC are to elect QEF status with respect to the second-tier PFIC (if possible) or be subject to the excess distribution rules.

If a U.S. person elects the mark-to-market regime for “marketable” stock in a PFIC, the U.S. investor includes in income each taxable year an amount equal to the excess, if any, of the fair market value of the PFIC stock at the close of the taxable year over the investor's adjusted basis in the stock. Similarly, the U.S. investor deducts the excess, if any, of the U.S. investor's adjusted basis in the PFIC stock over its fair market value at the close of each taxable year. However, the U.S. investor's deduction is limited to the net mark-to-market gains (reduced by any prior deductions) that the U.S. investor has included in income from this stock in previous taxable years.

Reading Assignment

- IRC §1296
- Treasury Regulation §§1.1296-1&2

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Legislative History

The mark-to-market concept adopted in the 1997 TRA had been floating around for some time. Previously, it was always part of a draconian "simplification" of the various anti-deferral regimes. Although IRC §1296 is almost word-for-word the same as prior proposals, it differs in one critical respect.

All prior mark-to-market proposals had made mark-to-market treatment mandatory for holders of "marketable stock" in a PFIC. If the 1997 TRA had not made the mark-to-market rules elective, any U.S. investor holding an interest in marketable stock would have had immediate recognition of all unrealized appreciation in such stock, and this is one of the elements that made prior versions draconian. Fortunately, the mark-to-market regime was not enacted in that form.

Because IRC §1296 is elective, U.S. investors in marketable stock of PFICs can choose which of the various PFIC taxing regimes — excess distribution, QEF (when available), or mark-to-market — is best for them. Moreover, many who wish to invest in offshore funds that will not make available information necessary to elect QEF treatment will find this mark-to-market treatment a boon.

Marketability

A PFIC investor may elect current taxation under the mark-to-market rules only if the PFIC stock is "marketable." PFIC stock is marketable if either: (1) it is regularly traded on a qualified exchange or other market; or (2) it constitutes certain other stock described in regulations. In addition, options on PFIC stock are considered marketable if the PFIC stock qualifies as marketable under either of the foregoing rules.

Taxation of U.S. Investors

The electing U.S. investor is required to mark its PFIC shares to market annually, and to include in gross income each taxable year an amount equal to the excess of the fair market value of the PFIC stock. as of the close of the taxable year over the adjusted basis of such stock. In effect, the U.S. investor will include the annual increase in value of the stock in its income. If the stock declines in value during the year, the U.S. investor is allowed a deduction for such decline in value, but only to the extent of "unreversed inclusions."

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Taxation of U.S. Investors (continued)

The regulations provide that the term “unreversed inclusions” means, with respect to IRC §1296 stock, the excess, if any, of the amount of mark-to-market gain included in the gross income of the U.S. person with respect to such stock for prior taxable years minus the amount allowed as a deduction to the U.S. person with respect to such stock for prior taxable years. The unreversed inclusion amount includes any amount subject to IRC §1291 under the coordination rules discussed below for the first year in which the mark-to-market election is in effect.

> **Example: T**, a U.S. person who is a calendar year taxpayer, acquired stock in D, a foreign corporation, on January 1, 2003, for $150. At such time and at all times thereafter D was a PFIC and T' s stock in D was marketable. For taxable years 2003 and 2004, T was subject to taxation under IRC §1291 with respect to the D stock. T made a timely §1296 election with respect to the D stock, effective for taxable year 2005. The fair market value of the D stock was $200 as of December 31, 2004, and $240 as of December 31, 2005. Additionally, D made no distribution with respect to its stock for the taxable years at issue. In 2005, T must include the $90 gain in the D stock in accordance with the rules of IRC §1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions, T will include the $90 of gain that was taxed under IRC §1291.

Any loss recognized on the sale or other disposition of §1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Code and the regulations thereunder.

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Basis Adjustments

To reflect the income and deductions entailed by the mark-to-market regime, the adjusted basis a U.S. investor has in its marketable PFIC stock is increased by the amount included in gross income under the regime, or is decreased by the amount of the deduction allowed under the regime. In the case of stock in a PFIC that a U.S. person is treated as owning via the attribution rules of IRC §1296(g), discussed below, the stock basis adjustments are made to the stock in the PFIC actually held by the intermediate person through whom the U.S. person is treated as owning the stock, but only for purposes of determining the subsequent tax treatment of the U.S. person. In addition, similar adjustments are made to the basis of the property through which the U.S. person is treated as owning the PFIC stock..

> **Example: B**, a U.S. person who is a calendar year taxpayer, purchased marketable stock in FC, a foreign corporation that was a PFIC, for $1,000 on January 31, 2003. B made a §1296 election with respect to the stock of FC for 2003. At the close of 2003, the fair market value of B's stock in FC was $1,200. B included $200 of mark-to-market gain as ordinary income for 2003, and increased his basis in the stock by that amount. On June 15, 2004, B sold his stock in FC for $900. At that time, B's unreversed inclusions with respect to the stock in FC were $200. Accordingly, B may deduct the amount equal to his unreversed inclusions, $200, as an ordinary loss. The $100 loss in excess of B' s unreversed inclusions is treated as a long-term capital loss because B held the FC stock for more than one year.

Character of Market To Market Gain & Holding Period

The income inclusions required by this regime are treated as ordinary income, as is any gain on the sale or other disposition of the marketable PFIC stock. Any amount allowed as a deduction under this regime is treated as an ordinary loss, as is any actual loss on the disposition of the stock, but only to the extent of unreversed inclusions. Any amounts treated as ordinary losses under this rules are also allowable as in computing adjusted gross income. In view of the reduction of individual capital gains rates, individual U.S. investors may find the market-to-market election less attractive.

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Election Requirement

A U.S. investor makes the IRC §1296 mark-to-market election for his or her investment in a PFIC by checking the box on line F of Part I of Form 8621(Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) and reports the gain or loss on Part III of the form. The election is applicable to the taxable year for which it is made, and to all subsequent taxable years, unless the stock ceases to be marketable, or the IRS consents to the revocation of the election.

According to the regulations, the election must be made on or before the due date (including extensions) for the return, and must be included with the original or amended return filed on or before such date.

Because a CFC is treated as a U.S. person for purposes of §1296 the CFC can elect mark-to-market treatment. A §1296 election by a CFC is actually made by its controlling U.S. shareholders, as defined in Regs. §1.964-1(c)(5), and must be included with Form 5471(*Information Return of U.S. Persons With Respect To Certain Foreign Corporations*) for that CFC by the due date (including extensions) of the original income tax returns of the controlling U.S. shareholders for that year. A §1296 election by a CFC is binding on all U.S. shareholders of the CFC. Where a CFC has foreign interest-holders, this election may require their consent as a matter of local company law.

A late or retroactive §1296 election is permitted only in accordance with the IRC §9100 regulations. Because the due date for the election is controlled by the regulations, rather than the statute, Regs. §301.9100-2(b) allows an automatic six-month extension of time to make the election. Any request for a further extension would be made under Regs. §301.9100-3. The IRS generally will grant a further extension when it can be established that the taxpayer acted reasonably and in good faith and the extension would not otherwise prejudice the interests of the government.

Summary

Passive Foreign Investment Company

A passive foreign investment company (PFIC) is any foreign corporation if (1) 75 percent or more of its gross income for the tax year consists of passive income, or (2) 50 percent or more of its assets consist of assets that produce or are held for the production of passive income.

Two Separate Tax Regimes

Two alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC. One set of rules applies to PFICs that are qualified electing funds (QEF), under which electing U.S. shareholders include currently in gross income their respective shares of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not QEFs (nonqualified funds), under which the U.S. shareholders pay tax on income realized from the PFIC and an interest charge that is attributable to the value of deferral.

Nonqualified Funds

Any U.S. shareholder of a PFIC, not making the election to be a QEF, is potentially taxable under IRC § 1291 on receipt of a distribution paid by the PFIC or upon disposition of the stock in the PFIC. IRC § 1291 imposes tax that includes an interest charge based on the value of tax deferral on income realized from a PFIC. IRC § 1291 taxes a shareholder of a PFIC when that U.S. shareholder receives an “excess distribution” in respect of stock.

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Allocation among Taxable Years

When an U.S. shareholder receives an “excess distribution, it is first allocated among all the days in the shareholder’s holding period for the stock of the PFIC. Second, the shareholder’s gross income for the current year includes the sum of all amounts allocated to 1) the current year and 2) any period in the holding period during which the foreign corporation was not a PFIC.

The amounts allocated to the current year and the year(s) of the shareholder’s holding period before the foreign corporation was a PFIC, if any, are included in current income and taxed as ordinary income.

The amounts allocated to prior taxable years (after 1986) after the foreign corporation became a PFIC have an indirect effect on the current year’s taxes, by increasing the tax of the current year by the “deferred tax amount," but not increasing the income.

Computation of Deferred Taxes and Interest

The “deferred tax amount” is calculated with respect to that portion of the excess distribution that is allocated to prior PFIC years and not included in current income. It equals the sum of deferred taxes and interest on those taxes. The deferred taxes equal the sum of the taxes that would have applied to the parts of the excess distribution allocated to years other than the current year and other years before the first taxable PFIC year. Taxpayers must compute the deferred taxes using the highest applicable rate.

Market to Market Election

A market to market election is available to a U.S. person who owns marketable stock in a passive foreign investment company. This election effectively provides for current taxation (at ordinary income rates) of appreciation in value of his or her PHIC stock. Adjustment to the basis of the PHIC stock is required each year income or loss is recognized.

Instructor Notes

Display and state the *Objectives again*. May use flipcharts, transparency, and PowerPoint slides.

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International Technical Training

Chapter 16

Subpart F Income

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 5.5 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and examples
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide

Overview

Instructor Notes

This chapter discusses in some depth the Subpart F Income and Investment of Earnings in U.S. Property, both of which are reportable by a CFC. The class will look at numerous examples. Audit techniques will also be discussed.

Introduction

One type of entity which foreign operations may be conducted through is a foreign corporation. A major tax advantage of using a foreign corporation to conduct foreign operations is tax deferral. U.S. tax on the income of a foreign corporation is deferred until the income is distributed as a dividend by the foreign corporation to its U.S. shareholders.

Prior to the enactment of Subpart F, many U.S. taxpayers achieved deferral of U.S. tax on certain kinds of easily movable income, such as dividends, interest, rents and royalties, by earning such income through foreign corporations. In addition, by placing such subsidiaries in low- or no-tax jurisdictions, U.S. taxpayers were able to reduce significantly their overall tax liability. Congress disapproved of these arrangements, since they resulted in significant tax avoidance both in the United States and abroad.

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The Subpart F provisions eliminate certain deferrals of U.S. income tax by requiring the taxation of certain U.S. shareholders on certain categories of the undistributed income of their foreign subsidiaries. This approach is based on the principles underlying the United States' taxing jurisdiction.

In general, the United States has no authority to tax a foreign corporation if the foreign corporation neither receives U.S. sourced income nor engages in U.S. based activities. However, the United States does have authority to tax all income wherever derived of U.S. persons. The Subpart F rules operate by requiring certain U.S. shareholders of foreign subsidiaries to include in income the U.S. shareholder's proportionate share of certain categories of its subsidiary's current earnings and profits. The U.S. shareholder is required to report this income currently in the United States whether or not the foreign subsidiary actually pays a dividend.

Subpart F, therefore, does not tax the foreign corporation. Rather, its rules apply only to a U.S. person who owns, directly or indirectly, 10 percent or more of the stock of a foreign corporation that is controlled by U.S. persons.

The provisions of Subpart F are exceedingly intricate and contain numerous general rules, special rules, definitions, exceptions, exclusions and limitations which require careful consideration.

Objective

At the end of this chapter:

- The student should have gained some level of understanding concerning Subpart F Income, how it is taxed, exceptions and other limiting factors such as E & P.

Continued on next page

Contents

This lesson covers the following topics:

References

- IRC §§ 951 through 964
- Treasury Regulations.

Lesson 1

Subpart F Overview and Stock Ownership

Overview

Background

Under Subpart F, certain types of income earned by a controlled foreign corporation (CFC) are includible in income by the CFC's "U.S. shareholders" in the year earned even though the CFC does not distribute the income to its shareholders. The undistributed income of a CFC that is includible by its U.S. shareholders under the Subpart F rules is referred to as "Subpart F income."

There are many categories of Subpart F income. In general, it consists of movable income. For example, a major category of Subpart F income consists of investment income such as dividends, interest, rents and royalties. Other forms of Subpart F income include income received by a CFC from the purchase and sale of personal property involving a related person and from the performance of services by or on behalf of a related person.

The Subpart F rules were first enacted as part of the Revenue Act of 1962. Since then, they have been amended numerous times. In particular, the Tax Reform Act of 1986 significantly expanded the coverage of Subpart F. However, subsequent acts have added exceptions and the American Jobs Creation Act of 2004 repealed foreign base company shipping income. Congress' continuing effort to define the parameters of Subpart F is evidence that Subpart F's policy – denial of tax deferral for movable income earned through a U.S. controlled foreign corporation formed in a low- or no-tax country – remains as viable today as when the rules were first enacted in 1962.

There are three basic requirements for the applicability of the Subpart F rules to a U.S. person that owns an interest in a foreign corporation:

- The U.S. person must be a "U.S. shareholder."
- The foreign corporation must be a "CFC."
- The CFC must have Subpart F income.

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References

- IRC § 957 – CFC, U.S. Persons
- IRC § 951(b) – U.S. Shareholder
- IRC § 958(a) – Direct and Indirect Ownership
- IRC § 958(b) – Constructive Ownership
- IRC § 898(c)(1) – CFC's Taxable Year
- IRC § 951(a)(1) – Amount Included in Gross Income
- IRC § 951(a)(2) – Pro Rata Share
- Treas. Regs. § 1.957-1(a) to (c) – Definition of CFC

Objective

At the end of this lesson, you will be able to:

- Determine which foreign corporations are CFCs.

Background

In his tax message to Congress in 1961, President Kennedy proposed the elimination of tax deferral for all U.S. owned firms operating outside of the United States through foreign subsidiaries. This proposal, which represented a major shift in U.S. tax policy, was prompted by the need to raise revenues to offset a deteriorating balance of payments situation and to achieve equity in the tax treatment of domestic companies and offshore subsidiaries. U.S. business leaders opposed the President's proposal fearing that the elimination of tax deferral would place U.S. businesses at a competitive disadvantage with foreign-owned companies. Nevertheless, in 1962, after extensive Congressional hearings and considerable negotiation and compromise, Congress adopted a limited form of President Kennedy's proposal, one which eliminated tax deferral only for certain kinds of income.

The provisions adopted by Congress in 1962 were codified at IRC § 951 through IRC § 964. The name "Subpart F" is used to refer to these sections because of their location in the Internal Revenue Code – Chapter I, Subchapter N, Part III, Subpart F.

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Purpose

Congress enacted Subpart F to eliminate the tendency of U.S. taxpayers to accumulate sizable earnings in their foreign corporations located in low- or no-tax countries in order to avoid paying United States and foreign tax. Subpart F's principal purpose, therefore, is to single out and tax currently certain low-taxed income earned by foreign corporations controlled by U.S. shareholders.

Taxation

Subpart F provides that certain types of income of a U.S. controlled foreign corporation, even if undistributed, must be included in the gross income of its U.S. shareholders in the year the income is earned by the foreign corporation.

Contents

This lesson covers the following topics:

Controlled Foreign Corporation (CFC)

Introduction

In order for Subpart F to apply to a U.S. shareholder of a foreign corporation, the foreign corporation must be a CFC.CFC was covered in chapter 4.

U.S. Shareholder

Introduction

In order for Subpart F to apply, there must be a U.S. shareholder.

In General

- IRC § 957(a) defines a CFC as any foreign corporation if more than 50 percent of its stock (by either vote or value) is owned by U.S. shareholder.
- IRC § 951(b) defines the term "U.S. shareholder" as a U.S. person who owns, within the meaning of IRC § 958, 10 percent or more of the total combined voting power of all class of stock in a foreign corporation.
- IRC § 957(c) defines the term "U.S. person" for purposes of Subpart F as generally having the meaning assigned to it by IRC § 7701(a)(30).

U.S. Person

IRC § 957(c)

IRC § 957(c) defines the term "U.S. person" for purposes of Subpart F by referencing the definition in IRC § 7701(a)(30), which defines a U.S. person as any of the following:

- A citizen or resident of the U.S.
- A domestic partnership.
- A domestic corporation.
- Any estate or trust that is not a foreign estate or trust as defined in IRC § 7701(a) (31).

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U.S. Shareholder, Continued

U.S. Shareholder

IRC § 951(b)

IRC § 951(b) defines a U.S. shareholder with respect to any foreign corporation as a U.S. person who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

For purposes of determining whether a U.S. person is a U.S. shareholder with respect to a foreign corporation, the U.S. person may own stock in the foreign corporation directly, indirectly, or constructively. Rules governing the determination of when a U.S. person owns stock in a foreign corporation for purposes of Subpart F are discussed later in this lesson.

Less Than 10 Percent Ownership

The Subpart F rules require that the undistributed earnings and profits of a CFC must be included in the current gross income of only those persons who are U.S. shareholders with respect to the CFC. A shareholder of a foreign corporation who is a U.S. person but who owns less than 10 percent of the total combined voting power of all classes of stock of the foreign corporation is not a U.S. shareholder as that term is defined in IRC § 951(b). Such person has income from the CFC only when such person receives a dividend from the CFC.

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Example 3

IRC §§ 957(a)(1) and 951(b)

X, a foreign corporation, has only one class of stock. Six unrelated shareholders own the following percentages of X's stock.

U.S. Persons

A – 15 percent
B – 30 percent
C – 5 percent
D – 5 percent
E – 20 percent

Foreign Person

F – 25 percent

X is a CFC because 65 percent of the total combined voting power of all classes of X's stock is held by three U.S. persons who are U.S. shareholders, A, B and E, each of whom owns at least 10 percent of X's only class of stock.

Although C and D are U.S. persons, they are not U.S. shareholders because each owns less than 10 percent of X's only class of stock.

F is not a U.S. person and, therefore, is not a U.S. shareholder.

Read

- IRC § 957(c) – U.S. Person
- IRC § 951(b) – U.S. Shareholder.

Stock Ownership

Introduction

IRC § 957(a) defines a CFC as any foreign corporation if U.S. shareholders own more than 50 percent of its voting stock or more than 50 percent of its stock by value. IRC § 951(b) defines a U.S. shareholder as any U.S. person who owns at least 10 percent of a foreign corporation's voting stock. Whether stock in a foreign corporation is owned by U.S. persons for purposes of the definition of a CFC or the definition of a U.S. shareholder is determined by applying the rules of stock ownership in IRC § 958.

Rules

IRC § 958 is divided into two subsections:

- IRC § 958(a) provides rules for determining when stock of a foreign corporation is owned by U.S. persons directly and indirectly through foreign entities.
- IRC § 958(b) provides rules for determining when stock of a foreign corporation is owned constructively by U.S. persons.

Direct Ownership

For purposes of Subpart F, stock owned includes stock owned directly by a U.S. person.

IRC § 958(a)(1)(A).

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Indirect Ownership

IRC § 958(a)(2)

For purposes of Subpart F, stock owned also includes stock owned indirectly through one or more foreign entities. Stock owned by a foreign corporation, foreign partnership, or foreign trust or estate is considered as being owned proportionately by the foreign entity's shareholders, partners, grantors or other persons treated as owners of any portion of the trust that includes the stock, or beneficiaries, respectively. For purposes of reapplying the indirect ownership rules, stock considered to be owned indirectly by a foreign entity is treated as if it were actually owned by such foreign entity.

Indirect ownership exists only through foreign entities. There is no indirect ownership through a domestic entity.

The attribution rules in IRC § 958(a)(2) create a chain of ownership running down through a chain of foreign entities. However, because the rule applies only to stock owned by a foreign entity, attribution of ownership stops with the first U.S. person in the chain of ownership running upward from the foreign entity whose ownership is being tested.

Example 4

IRC § 958(a)(2)

U.S. persons A and B each own directly 50 percent of foreign corporation U, which owns directly 60 percent of foreign corporation V.

A and B are each a 30 percent indirect shareholder of V (50% × 60% = 30%).

Note that if U were a domestic corporation, under the indirect ownership rules in IRC § 958(a)(2), neither A nor B would have any indirect ownership in V.

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Example 5

IRC § 958(a)(2)

C, a U.S. corporation, owns 100 percent of D, another U.S. corporation. D owns 75 percent of foreign corporation X, which owns 60 percent of foreign corporation Y, which in turn owns 80 percent of foreign corporation Z.

Under the direct ownership rule in IRC § 958(a)(1)(A), D owns directly 75 percent of X. Under the indirect ownership rule in IRC § 958(a) (1) (B), D is considered as owning 45% of Y (75% × 60% = 45%) and 36% of Z (75% × 60% × 80% = 36%).

For purposes of Subpart F, C is not considered as owning directly or indirectly any part of X, Y or Z. See IRC § 958(a).

Constructive Ownership

IRC § 958(b)

In addition to the ownership of stock under the direct and indirect ownership rules of IRC § 958(a), a person may be deemed to own the stock of a foreign corporation as a result of the constructive ownership rules in IRC § 958(b).

IRC § 958(b) provides that the attribution rules contained in IRC § 318(a), as modified by IRC § 958(b), shall apply for purposes of determining who constructively owns the stock of a foreign corporation.

Under IRC § 318(a), a person is deemed to own stock that is owned by various related parties. IRC § 318(a) includes both “from-entity” and “to entity” attribution rules. For example, stock owned by a corporation, partnership, or trust or estate is generally considered to be owned proportionately by the entity’s shareholders, partners, or beneficiaries, respectively (that is, attribution is *from* the entity to its owners). *See IRC § 318(a) (2).* In addition, stock owned by a shareholder, partner, or beneficiary is considered to be owned proportionately by the corporation, partnership, or trust or estate in which the shareholder, partner, or beneficiary, respectively, has an interest (that is, attribution is to an entity from its owners). *See IRC § 318(a) (3).*

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Constructive Ownership (continued)

In applying the rules of attribution in IRC § 318(a), IRC § 958(b) makes several modifications. These include the rule that states for purposes of applying the "from-entity" attribution rules in IRC § 318(a)(2), a corporation, partnership, trust, or estate that owns more than 50 percent of the voting stock of a corporation shall be considered as owning 100% of the voting stock of such corporation. *See IRC § 958(b) (2)*. Significantly, the Tax Reform Act of 1986 did not extend this rule to apply to cases where an entity owns less than 50 percent of the voting stock but more than 50 percent of the value of a corporation.

Unlike IRC § 958(a), IRC § 958(b) allows attribution of stock ownership from one U.S. person to another U.S. person. For example, stock of a foreign corporation that is owned by a U.S. corporation is constructively owned by a U.S. shareholder of the U.S. corporation. *See Treas. Reg. § 1.958-2(g), Example (2).*

As a general rule, the "to-entity" attribution rules may not be applied so as to treat a U.S. person as owning stock that is owned by a non-U.S. person. For example, a U.S. corporation does not constructively own stock owned by a foreign corporate shareholder. *See Treas. Reg. § 1.958-2(g), Example (3).*

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Example 6

IRC § 958(b)(2)

U.S. persons A and B each owns directly 30 percent of foreign corporation U's only class of stock. U owns directly 60 percent of foreign corporation V's only class of stock.

Under the indirect ownership rule in IRC § 958(a) (1) (B), A and B are each considered as owning indirectly 18 percent of V (30% × 60% = 18%).

Since U owns more than 50 percent of V's stock, U is treated as owning 100 percent of V. *See IRC § 958(b) (2).* A and B each constructively owns 30 percent of V (30% × 100% = 30%).

Because A and B each constructively own 30 percent of V's only class of stock, each is a U.S. shareholder with respect to V.

V is a CFC because 60 percent (30% + 30% = 60%) of its only class of stock is owned by U.S. shareholders. *See IRC § 957(a).*

Options

Treas. Reg. § 1.958-2(e)

When applying the constructive ownership rules in IRC § 958(b), any person having an option to acquire stock is treated as actually owning such stock.

Coordinating Different Ownership Rules

Treas. Reg. § 1.958-2(f)(2)

The stock ownership rules in IRC § 958(a) and IRC § 958(b) may result in different amounts of stock being treated as owned by a single U.S. person. (Usually, the indirect ownership rule in IRC § 958(a)(2) results in less attributed stock than the constructive ownership rules in IRC § 958(b).) Under Treas. Reg. § 1.958-2(f)(2), stock considered to be owned by a person is the amount that is the largest total percentage of stock treated as owned under one of the stock ownership rules in IRC §§ 958(a) and 958(b).

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Subpart F Inclusions

IRC § 951(a)(1)

The direct and indirect ownership rules of IRC § 958(a) and not the constructive ownership rules of IRC § 958(b) are used to determine the percentage of stock in a CFC that is owned by a U.S. shareholder for purposes of computing the amount of Subpart F income currently includible in the U.S. shareholder's gross income. IRC § 951(a)(1) provides that Subpart F income is taxable only to those U.S. shareholders who own stock within the meaning of IRC § 958(a) and Regulation 1.958(f)(2).

U.S. shareholders are required to include their pro rata shares of the Subpart F income of a CFC in their gross incomes, even though they own the CFC indirectly through a chain of other CFCs that have no Subpart F income.

Read

- IRC § 958(a) – Direct and Indirect Ownership
- IRC § 958(b) – Constructive Ownership.

CFC's Taxable Year

Required Taxable Year

IRC § 898

For tax years beginning after July 10, 1989, if more than 50 percent of a CFC's total voting power or total value is owned (or is treated as being owned under the stock ownership rules of IRC § 958) by a U.S. shareholder, the CFC must conform its tax year to the tax year of such shareholder.

A U.S. shareholder that owns (directly, indirectly, or constructively) more than 50 percent of a CFC's total voting power or total value is referred to as a "majority U.S. shareholder."

If more than 50 percent of the stock (by either vote or value) of a CFC is acquired by a single U.S. shareholder having a taxable year different from the CFC's taxable year, such shareholder will qualify as a majority U.S. shareholder. Accordingly, the CFC will be required to change its taxable year to conform to the taxable year of such majority U.S. shareholder. If it chooses, the CFC may elect a taxable year beginning one month earlier than the majority U.S. shareholder.

Because of the applicability of the stock ownership rules of IRC § 958, it is possible that a single CFC will have more than one majority U.S. shareholder. If a CFC has more than one majority U.S. shareholder, all of whom have the same tax year, the CFC will be required to adopt that tax year. If a CFC has more than one majority U.S. shareholder, and all such shareholders do not have the same tax year, the CFC will be required to adopt a tax year prescribed by regulations.

Currently, there are only proposed regulations under IRC § 898. They provide the only current guidance for complying with IRC § 898.

Read

IRC § 898(c)(1) – CFC's Taxable Year.

Taxation of Subpart F Income

Introduction

A U.S. shareholder of a CFC is taxed currently on its pro rata share of the CFC's Subpart F income.

In General

IRC § 951(a)(1)

IRC § 951(a)(1)(A)(i) requires a U.S. shareholder of a foreign corporation meeting certain ownership requirements to include in its gross income the sum of its pro rata share of the foreign corporation's Subpart F income.

In addition, IRC § 951(a)(1)(A)(ii) and (iii) requires a U.S. shareholder of a foreign corporation meeting certain ownership requirements to include in its gross income the sum of the foreign corporation's previously excluded Subpart F income withdrawn during the taxable year from certain qualified investments. Under prior law, a CFC could exclude from its Subpart F income certain amounts invested in less developed countries and in foreign base company shipping operations. To the extent these amounts are withdrawn from these favored investments, they no longer qualify for tax deferral and must be included currently in the income of the CFC's U.S. shareholders in the year of withdrawal.

Finally, IRC § 951(a)(1)(B) requires a U.S. shareholder of a foreign corporation meeting certain ownership requirements to include in its gross income the amount determined under IRC § 956 with respect to the shareholder for the taxable year.

The definitions of Subpart F income and income from the increase in a CFC's investment in U.S. property are discussed in later lessons.

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Ownership Requirements

IRC § 951(a)(1)

A U.S. shareholder is subject to the current inclusion rules of IRC § 951(a)(1)(A) and (B) only if the following two requirements are met:

- The foreign corporation was a CFC for an uninterrupted period of 30 days or more during the taxable year; and
- The U.S. shareholder owned stock directly or indirectly (as determined under IRC § 958(a)) in the foreign corporation on the last day of such taxable year.

Pro Rata Share

IRC § 951(a)(2)

If a foreign corporation qualifies as a CFC for its entire taxable year, a U.S. shareholder's pro rata share of a CFC's Subpart F income for that taxable year is the amount the U.S. shareholder would have been entitled to receive if the CFC had actually distributed its Subpart F income to its shareholders at the end of that taxable year.

If a foreign corporation qualifies as a CFC for only part of its taxable year, the amount taxable to a U.S. shareholder of the CFC is limited to the amount of the U.S. shareholder's pro rata share of the foreign corporation's Subpart F income that is attributable to the period that the foreign corporation qualified as a CFC. In other words, a U.S. shareholder's pro rata share of the Subpart F income of a foreign corporation that is a CFC for only part of a year equals that amount that bears the same ratio to the CFC's Subpart F income as the part of such year during which the foreign corporation was a CFC bears to the entire year. This amount is represented by the following formula:

$$\boxed{\begin{array}{l}\textit{Pro rata share of CFC} \\ \textit{Subpart F income to} \\ \textit{U.S. shareholder}\end{array} = \begin{array}{c}\textit{Percent of} \\ \textit{stock owned} \\ \textit{at year end}\end{array} \times \begin{array}{c}\textit{Subpart} \\ \textit{F} \\ \textit{income}\end{array} \times \frac{\textit{Number of days the corporation was a CFC}}{\textit{Total number of days in the year}}}$$

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E&P Limitation

The Subpart F income of a CFC for a taxable year is limited to the CFC's current earnings and profits for that year. A U.S. shareholder's Subpart F inclusion, therefore, cannot exceed its pro rata share of the earnings and profits of its CFC.

In general, the earnings and profits of a CFC are computed under rules applicable to U.S. corporations as modified by regulations under Subpart F.

Acquisitions or Dispositions of CFC Stock During a Taxable Year

If a U.S. shareholder maintains the same interest in a CFC during the CFC's taxable year, its pro rata share of the CFC's Subpart F income equals the product of its ownership percentage and the total amount of the CFC's Subpart F income required to be included in the gross incomes of the CFC's U.S. shareholders.

If a U.S. shareholder either acquires or disposes of an interest in a CFC during the CFC's taxable year, its pro rata share of the CFC's Subpart F income equals the product of its ownership percentage and the amount of the CFC's currently includible Subpart F income that is attributable to the period during which the U.S. shareholder owned its CFC stock.

Example 7

Less than 100 Percent Ownership

During 1997, U.S. corporation A owned 100 percent of foreign corporation W, which owned 80 percent of foreign corporation X, which owned 80 percent of foreign corporation Y, which owned 100 percent of foreign corporation Z. Foreign corporation Y's required tax year is a calendar year.

During 1997, Y had Subpart F income of $2,000,000. On December 31, 1997, A's pro rata share of Y's Subpart F income is 64 percent (80% × 80%) of $2,000,000, or $1,280,000.

Continued on next page

Example 8 **Pro Rata Share**

Foreign corporation D, which is wholly owned by foreign individuals, earns $500,000 of Subpart F income during its taxable year ended June 30, 1991.

U.S. corporation C, a calendar year taxpayer, purchases 60 percent of the stock of foreign corporation D on March 31, 1991, from one of D's foreign shareholders. C holds the D stock through December 31, 1991.

Because more than 50 percent of D's stock is owned by C, a U.S. person, D is a CFC and C is D's majority U.S. shareholder. Accordingly, D will be required to change its tax year, which ends on June 30, 1991, to conform to the calendar year tax year of its majority U.S. shareholder. D will file a return for its tax year ended June 30, 1991, and then D will file a return for the short period July 1, 1991 through December 31, 1991. ***See*** *Prop. Reg. § 1.898-4(b) (3)*. [**Note**: Section 898 regs. are proposed only and not binding on taxpayers]

Because C acquired its interest in D on March 31, 1991, its pro rata share of D's Subpart F income that D earned during its tax year ended June 30, 1991, equals the product of C's ownership percentage (60 percent) and the amount of D's Subpart F income that is attributable to the three months during D's tax year that D was a CFC:

C's pro rata share	=	60% × (3/12 × $500,000)
	=	60% × $125,000
	=	$75,000

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Example 9 **Pro Rata Share**

Foreign corporation N has a single class of stock with 100 shares issued and outstanding. All of these shares are owned by foreign individuals.

On April 1, 1991, U.S. corporation M purchases from these individuals 80 shares in N.

On June 30, 1991, M sells 60 shares of the N stock that it had acquired three months earlier to an unrelated foreign individual. M does not acquire any additional stock in N during the remainder of 1991.

M is a calendar year taxpayer. N has a taxable year ending on September 30, 1991.

For its tax year ended on September 30, 1991, N had $100,000 of earnings and profits, all of which constituted Subpart F income.

N was a CFC for an uninterrupted period of 90 days during 1991. M was a U.S. shareholder of N on the last day of N's taxable year that N was a CFC.

M must include in its gross income for its 1991 calendar tax year its pro rata share of N's Subpart F income for its taxable year ended September 30, 1991. This amount equals the product of M's ownership percentage (80 percent) in N while N was a CFC and the amount of N's currently includible Subpart F income that is attributable to the 90 days during N's tax year that N was a CFC.

M's pro rata share	=	80% × (90/365 × $100,000)
	=	80% × $25,000
	=	$20,000

Read

- IRC § 951(a)(1) – Amount Included in Gross Income
- IRC § 951(a)(2) – Pro Rata Share
- Treas. Regs. § 1.951-1(b)(2) – Illustrations

Taxation of Subpart F Income

- The taxation of foreign income earned by CFCs drastically changed with the introduction of Subpart F into the Internal Revenue Code in 1962.
- Subpart F deals with the U.S. taxation of amounts earned by controlled foreign corporations (CFCs). It provides that certain types of income of CFCs, though undistributed, must be included in the gross income of the U.S. shareholder in the year the income is earned by the CFC.

U.S. Tax Standards

The rules contained in Subpart F are to be applied after the income of the CFC has been adjusted to conform to U.S. income tax concepts.

CFCs and IRC § 482

- Active business operations conducted by foreign corporations are generally not affected by the Subpart F provisions.
- Under most circumstances, current earnings of a CFC may be deferred from U.S. tax if not actually distributed to the U.S. shareholder.
- Since domestic entities are currently taxed, it is essential that the relationships between CFCs and domestic entities be at arm’s length.
- Allocations of income and deductions between the CFC and its related organizations under IRC § 482 take precedence over the application of the provisions of Subpart F, but, CFC provisions apply even when dealings with the parent and subsidiaries are at arm’s length.

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Preliminary Information

- Your first step should be to become familiar with the taxpayer operations. You must be knowledgeable of all the entities involved and the products or services produced or rendered.
- Obtain consolidated financial statements showing balance sheets and operating results of all related domestic and foreign entities.
- Obtain certified statements of individual foreign entities. If the books and records are not maintained in English, the Regulations provide for an accurate English translation or the services of a qualified interpreter (Treas. Reg. § 1.964-3(a) (2).
- Obtain a statement from the taxpayer characterizing the operations of the various related foreign entities.
- Obtain minute books of domestic taxpayer and related foreign entities.
- Obtain copies of all foreign tax returns filed by related foreign entities in which the taxpayer is a U.S. shareholder.
- Obtain an organizational chart showing relationship of domestic and foreign entities and showing stock ownership percentages.
- Examine copies of existing company publications, manuals, instructions, or correspondence which set forth procedures dealing with foreign income reporting.
- Ask for a briefing on changes in accounting procedures designed to meet the requirements relating to IRC § 951. This should be done at the first meeting with the U.S. shareholder or his representative.

Planning the Audit

- Since Subpart F contains numerous relief provisions, the early stages of the examination should be devoted to the applicability of exclusions; starting with those most easily verified. If you have doubts regarding the applicability of Subpart F to some income it may be a good idea to discuss it with the taxpayer, such discovery may save you a lot of time.
- Audit steps requiring detailed documentation and extensive analyses should be pursued only after determining that most apparent relief measures are not applicable.

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Guidelines

- Determine if Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, and income statements plus balance sheets have been filed indicating the existence of a CFC.
- Analyze the balance sheet and P&L statements on Forms 5471 indicating Subpart F income.
- Compare current Forms 5471 with prior and subsequent years and look for any organization or reorganization of foreign corporations or any stock acquisition.
- Determine if Form 8858, *Information Return of U.S. Persons With Respect to Disregarded Entities*, has been filed.
- Analyze U.S. taxpayer's "investment account" and stock records to ascertain ownership in foreign corporations.
- If there is no investment account on the books, items which might indicate a foreign investment could include:
- Foreign source income.
- Foreign legal fees.
- Foreign travel expenses.
- Foreign tax paid.
- Foreign travel.

Continued on next page

Guidelines (continued)

- Determine direct, indirect, and constructive ownership of voting power of stock in any foreign corporations.
  - It is important to note that the ownership rules relate to voting power of stock.
  - Be alert to attempts to shift formal voting power to avoid qualification. See Treas. Reg. § 1.951-1(g)(2) and 1.957-1(b)(2) for illustrated situations.
- Determine value of stock, including whether any shares have different rights resulting in different values, and ownership of value of stock.
- Determine who is in actual control of the foreign corporation if the U.S. shareholders appear to be in the minority.
- The CFC's stock record book may indicate ownership of a subsidiary. By applying the indirect ownership rules, a subsidiary of a CFC, if ownership is sufficient, may be considered to be a CFC.
- If a taxpayer owns 10 percent or more of a foreign corporation, an analysis of the records may indicate the existence of other U.S. shareholders.
  - Analysis might disclose other owners of the stock that constructively or indirectly might qualify the foreign corporation as a CFC.

Summary

CFC Defined

A CFC is a foreign corporation which is more than 50 percent owned by vote or value by U.S. persons, each of whom own at least 10 percent of the voting stock of the foreign corporation.

50 Percent Ownership

For purposes of applying the more than 50 percent (or more than 25 percent in the case of foreign corporations that are insurance companies) test for stock ownership of foreign corporations, ownership includes:

- Direct ownership
- Indirect ownership
- Constructive ownership

The applicable rules for indirect and constructive ownership of stock are contained in IRC § 958(a) and (b), respectively.

Indirect vs. Constructive Ownership

- Because the indirect ownership rules usually result in a lower percentage interest than the constructive ownership rules, the indirect ownership rules are primarily used to determine the percentage of stock owned by a U.S. shareholder of a CFC. This percentage is used to compute the amount of the income of a CFC which is includible in the gross income of a U.S. shareholder of the CFC, under the provisions of Subpart F.
- The constructive ownership rules are used to determine:
  - Who is a U.S. shareholder?
  - Whether more than 50 percent of the stock of a foreign corporation is held by one or more U.S. shareholders.
  - Whether stock is held constructively for purposes of other stock ownership rules and relationship tests, which are contained in Subpart F.

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U.S. Shareholder Defined

A U.S. shareholder is a U.S. person (defined in IRC § 957(c)) who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation.

Amounts Included – IRC § 951(a)

- If the taxpayer qualifies as a U.S. shareholder under IRC § 951(b), and
- Owns stock in the CFC directly or indirectly, under IRC § 958(a), and
- If the foreign corporation in question is a CFC for the requisite period,

then further analysis may be necessary to determine the taxability under IRC § 951(a)(1)(A) and IRC § 951(a)(1)(B).

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Amounts Included – IRC § 951(a) (1) (A)

Amounts included in the gross income of a U.S. shareholder consists of:

1. Subpart F Income (IRC § 952), consisting of:
   - Income from insurance of certain risks outside the home country (IRC § 953);
   - Foreign Base Company Income under IRC § 954 consisting of:
     - Foreign Personal Holding Company Income,
     - Foreign Base Company Sales Income,
     - Foreign Base Company Services Income,
     - Foreign Base Company Shipping Income for tax years of CFCs beginning before 12/31/2004, and
     - Foreign Base Company Oil Related Income;
   - Income as determined according to IRC § 999, International Boycott;
   - Illegal bribes, kickbacks, or other payments unlawful under the Foreign Corrupt Practices Act of 1977 (**Note**: IRC § 162(c) was amended by the 1982 Tax Equity and Fiscal Responsibility Act);
   - Income of the CFC derived from any country to which IRC § 901(j) applies.
2. Previously excluded Subpart F income withdrawn from investment in less developed countries as defined in IRC § 955;
3. Previously excluded Subpart F income withdrawn from investment in shipping operations as defined in IRC § 955.

Amounts Included – IRC § 951(a) (1) (B)

Amounts determined under IRC § 956 (Investment of Earnings in U.S. Property).

Lesson 2

Investment of Earnings in U.S. Property

Overview

Background

IRC § 951(a) (1) (A) lists all the types of income which are to be included in the gross income of a U.S. shareholder of a CFC although they were not distributed by the CFC.

- IRC § 951(a) (1) (A) (i) states that the U.S. shareholder must include and thus includible in gross income it's pro rata share of the CFC's Subpart F income.

We have covered this previously and we were primarily concerned with Foreign Base Company Income. This type of income is considered "tainted" where the purpose is to set up a foreign base company so that income can be earned in a low tax foreign country and thus escape U.S. and foreign tax.

- IRC § 951(a) (1) (B) states that the amount described in IRC § 956 is includible in a U.S. shareholder's gross income.

This lesson will be dealing with IRC § 956.

- IRC § 951(a) (1) (C), repealed by the Small Business Job Protection Act of 1996, states that the amount described in IRC § 956A is includible in a U.S. shareholder's gross income.

IRC § 956A became effective for years beginning after 9-30-93 and was repealed for years starting on or after 1-1-97. We will not be concerned with taxation under IRC § 956A.

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Basic Rules of IRC § 956

- U.S. shareholders of a CFC are required to include in gross income their proportionate share of certain income of the CFC regardless of whether it is distributed.
- A U.S. shareholder is any U.S. person that owns 10 percent or more of the total combined **voting** power of the CFC either **directly** or **indirectly** on the last day of the CFC's tax year. A U.S. person includes an entity.
- A foreign corporation is a CFC if **more** than 50 percent of its total voting power or value is owned by U.S. shareholders for an uninterrupted period of 30 days or more during the tax year.
- A U.S. shareholder's gross income includes earnings of the CFC invested in "U.S. property" during the tax year.
- A U.S. shareholder's proportionate share of CFC earnings invested in U.S. property is the lesser of:
  - The CFC's average investment in U.S. property as of the close of each quarter of the tax year but only to the extent that they have not been previously taxed (IRC § 956(a)(1)), or
  - The CFC's current or accumulated earnings reduced by any distributions made during the tax year and by earnings previously subject to U.S. taxation (IRC § 956(a)(2)).

Objective

At the end of this lesson, you will be able to:

- Compute a CFC's investment of earnings in U. S. property.

Important Concepts in This Lesson

- Definition of U.S. property IRC § 956(c) (1).
- Exceptions to U.S. property IRC § 956(c) (2).
- Computation of investment in U.S. property.
- Recognition of situations which trigger IRC § 956.

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Contents

This lesson covers the following topics:

History

Background

For taxable years of a CFC beginning before 9-30-93 IRC § 951(a)(1)(B) required a U.S. shareholder of a CFC to include in gross income its pro rata share of increase in the earnings invested by the CFC in U.S. property in the taxable year as determined by IRC § 956.

- IRC § 951(a) – Requires the current inclusion in the gross income of the U.S. shareholder.
- IRC § 956 – Defines the amount that is subject to current inclusion.

For example, a CFC has 200M net income from manufacturing activity (not Subpart F); it lends the entire amount to its U.S. parent.

Based on what we learned prior to this lesson, this manufacturing income of the CFC is not subject to U.S. taxation because:

- It is earned by a foreign corporation outside the United States, and
- It is not Subpart F income.

This did not seem very fair to U.S. taxing authorities because the U.S. shareholder has use of funds on which U.S. tax has been deferred.

IRC § 956 was enacted to prevent such escape of tax. Under IRC § 956 the 200M loan to the U.S. shareholder is includible in gross income and subject to U.S. tax.

The loan of 200M is an investment in a U.S. debt instrument (U.S. property) of a related party in the current year.

Prior to IRC § 956

- Prior to the enactment of IRC § 956, a domestic taxpayer could make use of funds, which were earned by its foreign subsidiary without creating a taxable event, as long as those funds were not in the form of a dividend.
- Under IRC § 956, if a controlled foreign corporation (CFC) has an investment in U.S. property, it may result in an inclusion by the U.S. shareholder in gross income, per IRC § 951(a) (1) (B).

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Theory of IRC § 956

A U.S. taxpayer's CFCs often build up significant cash reserves through their normal operations. The U.S. parent may want or need these funds in the United States for various reasons, such as:

- Growth capital in times of expansion.
- Operating expenses during an economic downturn.

IRC § 956 addresses this type of situation. A corporate parent normally receives a distribution in the form of a dividend from its subsidiary when those funds are needed. Congress felt that, even if a dividend has not been declared, if the parent has full use of these funds in the United States, the result is the same. Consequently, if the facts fall within the guidelines of IRC § 956, those investments in U.S. property are includible by the U.S. parent in gross income.

Legality of IRC § 956

IRC § 956 imposes a tax on a U.S. shareholder on certain amounts that are repatriated into the United States. The constitutionality of this statute has been challenged by taxpayers but has been rejected by the courts. *See: Estate of Whitlock v. Comm., 494 F.2d 1297 (C.A. 10 1974), and Albert L. Dougherty, 60 TC 917 (1973).*

Amounts Included in Gross Income of U.S. Shareholders

In General

- The Subpart F rules require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "Subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. IRC § 951(a) (1) (A) ((i).
- In addition, the U.S. 10-percent or greater shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year. IRC § 951(a) (1) (B).
- A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average quarterly investment in U.S. property for such year.
- The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject.
- The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of:
  - The controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or
  - The controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.
- An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as Subpart F income.

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Omnibus Budget Reconciliation Act of 1993

For taxable years of a CFC beginning after 9-30-93 (per the Omnibus Budget Reconciliation Act of 1993): A U.S. shareholder has to include in its gross income:

- Certain Investments in U.S. Property – IRC § 956, and
- Earnings invested in Excess Passive Assets – IRC § 956A. (REPEALED)

The inclusion of “Earnings Invested in Excess Passive Assets” was repealed for years after 1-1-97.

IRC § 951(a) (1) (B)

A U.S. shareholder has to include in his pro rata share the “amount” as determined under IRC § 956 (but only to the extent not excluded from gross income under IRC § 959(a) (2)). This will be explained later in greater detail.

Exclusion from Gross Income of Previously Taxed E&P

IRC § 959(a)(2)

- IRC § 959(a)(2) provides that investments in U.S. property from earnings attributable to Subpart F income previously taxed to a U.S. shareholder will not be taxed again. IRC § 959(c) provides that investments in U.S. property will be made first from earnings and profits attributable to previously taxed Subpart F income. IRC § 959 prevents the same amount from being subject to tax twice.
- For example, a CFC has only Subpart F income of 200M in a particular year, and lends the entire amount to its U.S. parent. The 200M of Subpart F income is includible in the U.S. shareholder’s gross income. Since the loan is U.S. property, the amount of the loan would be subject to inclusion in the U.S. shareholder’s gross income again if not for the exclusion under IRC § 959(a) (2).

U.S. Property

Introduction

- For IRC § 956 to be applicable the CFC must hold "U.S. property."
- U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.

Definition of U.S. Property

IRC § 956(c)(1)

U.S. property is defined in IRC § 956(c) as:

- Tangible property located in the U.S. (real and personal
- Stock of a domestic corporation
- Obligations of U.S. persons:
  - Bond
  - Note
  - Debenture
  - Certificate
  - Bill receivable
  - Account receivable
  - Note receivable
  - Open account
  - Other indebtedness
- Any right to the use in the U.S. of:
  - A patent or copyright
  - An invention, model or design
  - A secret formula or process
  - Any similar property right

Exceptions to U.S. Property

Trade Receivables

IRC § 956(c)(3)

U.S. property includes trade receivables if:

- It is acquired from a related U.S. person, and
- The obligor is a U.S. person.

In General – IRC § 956(c) (2)

Specified exceptions from the definition of U.S. property are provided for:

- Obligations of the United States, money, or deposits with persons carrying on the banking business;
- Property located in the United States which is purchased in the United States for export to, or use in, foreign countries.
- Obligations of a U.S. person arising in connection with the sale or processing of property if the amount outstanding does not exceed the amount that would be ordinary and necessary to carry on the trade or business of both the other party to the transaction and the U.S. person if the transaction had been made between unrelated parties.
- Aircraft, railroad, vessel, etc. used for transportation of persons or property in foreign commerce and used predominantly outside the United States.
- Assets of an insurance company equivalent to the ordinary and necessary unearned premiums or reserves attributable to contracts insuring risks other than risks located outside the CFC's country of incorporation as described in IRC § 953(a)(1).
- Stock or bond of a domestic corporation which is neither:
  - A U.S. shareholder of the CFC,

    nor
  - A domestic corporation 25 percent or more of the total combined voting power of which is owned by U.S. shareholders immediately after the acquisition of the stock by the CFC.

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In General – IRC § 956(c) (2) (continued)

- Moveable drilling rigs or barges or other moveable exploration equipment when used on the Continental Shelf of the United States.
- The amount of assets equivalent to the CFC's earnings and profits attributable to its U.S. source income effectively connected to a U.S. trade or business.
- Property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities;
- Certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and
- Certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.

It is clear from the above exceptions that where the CFC has legitimate business reasons for investing in the U.S. (for example, investment in a public corporation) it will not be subject to tax.

Statement Required

Treas. Reg. § 1.956-2(b)(2)

The regulations require the U.S. shareholder to attach a statement to his tax return setting forth specific information regarding property that is excluded from U.S. property.

Read

- IRC § 951(a)(1)(B) – Amount Included in Gross Income of U.S. Shareholder
- IRC § 956(c)(1) – U.S. Property Defined
- IRC § 956(c)(2) – Exceptions
- IRC § 956(c)(3) – Certain Trade Receivables

Act Section 407. U.S. Property Not to Include Certain Assets of a CFC

- House Bill Section: 307
- Title: U.S. Property Not to Include Certain Assets of CFC
- Code Section Affected: 956

The new provision provides for two new exceptions from the definition of **U.S. property**.

- The first exception generally applies to securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a **dealer in securities**. The exception applies only if the controlled foreign corporation dealer:
  1 accounts for the securities as securities held primarily for sale to customers in the ordinary course of business; and
  2 disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

Under IRC § 475(c)(1), the term "dealer in securities" means a taxpayer who regularly purchases and sells securities to customers in the ordinary course of a trade or business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. This definition is adopted for purposes of IRC § 956(c).

- The second exception applies to an obligation acquired by a CFC from a U.S. person that is not a domestic corporation and is not a U.S. shareholder of the CFC or a partnership, estate, or trust in which the CFC (or any related person) is a partner, beneficiary, or trustee after the acquisition of the obligation.

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Reason for Change

- Congress believed that the acquisition of securities by a controlled foreign corporation in the ordinary course of its business as a **securities dealer** generally should not give rise to an income inclusion as an investment in U.S. property under the provisions of Subpart F.
- Similarly, the acquisition by a controlled foreign corporation of obligations issued by unrelated U.S. noncorporate persons generally should not give rise to an income inclusion as an investment in U.S. property.
- The provision would allow CFCs that are dealers in securities to invest in U.S. securities under certain circumstances without incurring an investment in US property inclusion for their U.S. shareholders.

New Statute Section 407 U.S. Property Not to Include Certain Assets of CFC

SECTION. 407. UNITED STATES PROPERTY NOT TO INCLUDE CERTAIN ASSETS OF CONTROLLED FOREIGN CORPORATION.

(a) IN GENERAL. – *Section 956*(c)(2) (relating to exceptions from property treated as United States property) is amended by striking “and” at the end of subparagraph (J), by striking the period at the end of subparagraph (K) and inserting a semicolon, and by adding at the end the following new subparagraphs:

(K) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if –

(i) “the dealer accounts for the securities as securities held primarily for sale to customers in the ordinary course of business, and

(ii) “the dealer disposes of the securities (or such securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business; and

Continued on next page

New Statute Section 407 U.S. Property Not to Include Certain Assets of CFC (continued)

(L) "an obligation of a United States person which –
  (i) is not a domestic corporation, and
  (ii) "is not –
    (I) a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, or
    (II) "a partnership, estate, or trust in which the controlled foreign corporation, or any related person (as defined in section 954(d)(3)), is a partner, beneficiary, or trustee immediately after the acquisition of any obligation of such partnership, estate, or trust by the controlled foreign corporation."

(b) CONFORMING AMENDMENT. – Section 956(c) (2) is amended by striking "and (K)" in the last sentence and inserting, "(K), and (L)."

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of U. S. shareholders with or within which such taxable years of foreign corporations end.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of U. S. shareholders with or within which such taxable years of such foreign corporations end.

Act Section 837. Clarification of Banking Business for Purposes of Determining Investment of Earnings in U.S. Property

- House Bill Section: 837
- Title: Clarification of Banking Business for Purposes of Determining Investment in Earnings in U.S. Property
- Code Section Affected: 956

Under current law, an exception to U.S. property exists for obligations of the United States and money or deposits with persons carrying on **the U.S. Property banking business**. IRC § 956(c) (2) (A).

In The *Limited Inc. v. Commissioner*, the Court of Appeals for the Sixth Circuit found that a U.S. subsidiary of a U.S. shareholder was carrying on a banking business even though those operations were limited to the administration of a private label credit card program for the U.S. shareholder.

Thus the CDs purchased by a related CFC did not constitute an investment in U.S. property under IRC § 956.

The new provision defines "banking business" for purposes of the exception from the definition of U.S. property for deposits with persons carrying on a banking business. The credit card entity in *The Limited* would not qualify for this exception.

Limited Inc. v. Commissioner

- With regard to the exception for deposits with persons **carrying on the banking business** (IRC § 956(c) (2) (A)), the Code does not define what constitutes "carrying on the banking business."
- The U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner* concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder.
- The court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (for example, through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under IRC § 956 as an investment in U.S. property.

Continued on next page

Persons Carrying on the Banking Business – Defined by the AJCA

The new bill provides that the exception from the definition of U.S. property under IRC § 956 for deposits with **persons carrying on the banking business** is limited to deposits with:

- Any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c), without regard to paragraphs (C) and (G) of paragraph (2) of such section); or
- Any corporation which is not a bank, but in which a bank holding company or financial holding company, directly or indirectly owns more than 80 percent of vote or the value of the corporation's stock.

A bank is generally defined as any institution organized under U.S. law that accepts demand deposits and is engaged in the business of making commercial loans (12 U.S.C. §1841(c)). It also includes any bank in which the deposits are insured under the Federal Deposit Insurance Act.

New Statute for Section 837 Clarification of Banking Business

SECTION. 837. CLARIFICATION OF BANKING BUSINESS FOR PURPOSES OF DETERMINING INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

(a) IN GENERAL – Subparagraph (A) of section 956(c)(2) is amended to read as follows:

(A) 'obligations of the United States, money, or deposits with –

(I) 'any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)), without regard to subparagraphs (C) and (G) of paragraph (2) of such section), or

(II) 'any corporation not described in clause (i) with respect to which a bank holding company (as defined by section 2(a) of such Act) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation;

(b) EFFECTIVE DATE – The amendment made by this section shall take effect on the date of the enactment of this Act.

Continued on next page

American Jobs Creation Act of 2004 – Act Section 837, Continued

Effective Date

The amendment made by this section shall take effect on October 22, 2004 (Act Sec. 837(b) of the American Jobs Creation Act of 2004).

Investment in U.S. Property

Amount of Investment

Treas. Reg. § 1.956-1(e)

The amount taken into account with respect to any U.S. property is its adjusted basis reduced by any liability to which such property is subject. The liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the CFC will not be taken into account.

In General – Amount Taxable

We have already learned that if a CFC invests its earnings in U.S. property, for example, by purchasing the stock or bonds of its U.S. parent, then such parent may have an inclusion based on its pro rata share of the amount determined under IRC § 956.

Prior to 9-30-93, the tax was based on investment in U.S. property at the end of the taxable year. Under these rules if the investments were divested prior to the end of the year and again reinvested in the following year generally there would be no tax. However, property was treated as outstanding at year end if the period of year end disinvestment was short compared to the overall period of the debt obligation. *See: Rev. Rul. 89-73.*

This potential abuse was eliminated for years after 9-30-93 by measuring investments quarterly. For example, a CFC makes a loan of 200M to its U.S. parent on 3-1-96. The loan is repaid 10-1-96. It is the only investment in U.S. property of the CFC. The amount of investment "average at close of each quarter" is computed as follows:

3-31-96	200M
6-30-96	200M
9-30-96	200M
12-31-96	0
Total	600M / 4 = 150M

The 150M is includible in the gross income of the U.S. shareholder.

Read

Treas. Reg. § 1.956-1(e) – Amount Attributable to Property.

Inclusion in U.S. Shareholder's Gross Income

Amount Taxable

IRC § 956(a)

We know generally that the U.S. shareholder may have an inclusion under IRC § 951(a) (1) (B) based on the amount determined under IRC § 956 but, how does one compute the amount?

The amount determined under IRC § 956(a) is the LESSER of:

A. *The EXCESS of:*

1 The U.S. shareholder's pro rata share of the average amount of the U.S. property held by the CFC as of the close of each quarter.

OVER

2 E&P described in IRC § 959(c) (1) (A) – that is, E&P which was already taxed to the U.S. shareholder on account of the CFC's investment in U.S. property.

(IRC § 959(a) (2) and (c)(1) provide that investment in U.S. property is deemed first to come out of previously taxed Subpart F income. Thus, there is no IRC § 956 inclusion unless the investment exceeds previously taxed income).

B. *The shareholder's pro rata share of the "applicable earnings" (as defined in IRC § 956(b)) of the CFC.*

If you are not sure what this means, please pay close attention to the example that follows on the next page.

Continued on next page

Applicable Earnings

IRC §§ 956(b) and 956(b)(1)(A),(B)

1. CFC's accumulated E&P (see IRC § 316(a) (1)).
   PLUS
2. CFC' current E&P (see IRC § 316(a) (2)).
   LESS
3. Distributions made by the CFC during the taxable year.
   LESS
4. E&P accumulated in any year, which were previously taxed to the U.S. shareholder per IRC § 959(c).

Example 47: Year 1 (1994)

The following examples are from the Committee Reports on P.L. 103-66 (Omnibus Budget Reconciliation Act of 1993) regarding IRC § 956A. The examples are modified by substituting IRC § 956 for IRC § 956A.

- DC (U.S. corp.) owns 100 percent of FC (CFC).
- On 1-1-94 FC invests in U.S. property in the amount of $10 and continues to hold this investment through 12-31-94.
- 12-31-94 current plus accumulated E&P of FC is $25 (applicable earnings).

The amount taxable to DC is $10 (investment in U.S. property), because it is less than applicable earnings.

This rule is familiar to you from taxation of Subpart F income where the income taxable to the U.S. shareholder is limited to E&P.

The E&P on 12-31-94 is $25, of which $10 is classified in IRC § 959(c) (1) (A), that is, previously taxed as IRC § 956.

Continued on next page

Example 48: Year 2 (1995)

- On 1-1-95 FC invests an additional $5 in U.S. property.
- At each quarter end in 1995 FC has U.S. property of $15.
- During 1995 FC has Subpart F income of 5.
- 12-31-95 current E&P of FC is 5.

E&P on 12-31-95 is $30 and consists of the following:

From 1994 – (IRC § 959(c)(3))	–	$15	
From 1994 – (IRC § 959(c)(1)(A))	–	$10	***(previously taxed under IRC § 951(a)(1)(B) as 956)***
From 1995 – (IRC § 959(c)(2))	–	$ 5	***(previously taxed under IRC § 951(a) (1)(A) as Subpart F).***
Total current plus accumulated E&P 30		$30	

The taxable amount is the ***LESSER*** of:

C. The excess of U.S. property over E&P previously taxed under IRC § 959(c)(1)(A), or

D. Applicable earnings.

E. The excess of U.S. property over E&P previously taxed under 959(c)(1)(A):

1995 U.S. property	$15
Less: E&P described in IRC § 959(c)(1) (i.e., previously taxed as IRC § 956)	10
	$ 5

F. Applicable earnings:

Accumulated E&P	$30
Less: E&P described in IRC § 959(c)(1) (i.e., previously taxed as IRC § 956)	10
	$20

Continued on next page

Example 48: Year 2 (1995) (continued)

Thus $5 is the amount determined under IRC § 956 for 1995 (the lesser of A or B).

The $5, however, is deemed to consist of previously taxed Subpart F income under IRC § 959(a)(2) (that is, amount previously taxed as Subpart F). Thus, because the $5 has previously been included in the U.S. shareholder's gross income as Subpart F income, it is not again included as an IRC § 956 amount.

Example 49: Year 3 (1996)

Facts and Analysis of E&P

• From 1-1-96 through 12-31-96 FC holds U.S. property of	$15
• FC has Subpart F income (taxable to DC) of	5
• FC has other income of	10
• FC distributes to DC	20

How much is taxable to DC in 1996?

Our first step must be to compute and analyze the E&P as of 12-31-96 because the taxability of distributions and subpart F inclusion is based on E&P.

<u>FC has current and accumulated E&P of $45 on 12-31-96, before accounting for the distribution of $20 – consisting of the following:</u>

• Accumulated as 12-31-95 (see Example 48)	$30
• 1996 Subpart F income	5
• 1996 other income	10
Total E&P (before distribution)	$45

Our next step is to analyze the sources of $20 distribution.

Continued on next page

Example 49: Year 3 (1996) (continued)

Analysis of Distribution

The distribution of $20 is not taxable to DC because it is attributable to previously taxed earnings as follows:

G. Under IRC § 959(c)(1)

• Previously taxed in 1994 under IRC §§ 951(a)(1)(B) and 956	$10
• Previously taxed in 1995 under IRC §§ 951(a)(1)(B) and 956	5

H. Under IRC § 959(c)(2)

• Previously taxed in 1996 under IRC § 951(a)(1)(A), i.e., Subpart F	5
Total	$20

If you think about this analysis and remember our earlier discussion it all makes sense because we do not want to tax the U.S. shareholder twice that is, upon initial taxability under IRC § 951(a) and again upon distribution.

Our next step is to analyze the amount taxable under IRC § 956.

Continued on next page

Example 49: Year 3 (1996) (continued)

Analysis of IRC § 956

Our final step is to determine the "amount" under IRC 956, which in broad terms is the LESSER of:

- The excess of U.S. property held by the CFC over IRC 956 previously taxed income, or
- Applicable earnings.

I. Average U.S. property for each quarter in 1995. *$15*

There are no reductions to this amount under IRC § 959(c) (1) (A) because no portion of the E&P is treated as previously taxed under IRC § 959(a) (1) (B) and IRC § 956. The previously taxed amount as IRC § 956 was exhausted by the distribution of $20.

J. Applicable earnings consists of:

• Accumulated earnings as of 12-31-96 (prior to distributions)	$45
• Less: distribution during the year	20
	$25

There are no reductions to E&P under IRC § 959(c) (1) (A) because no portion of the E&P is treated as previously taxed under IRC § 951(a) (1) (B) & § 956. The previously taxed amount as IRC § 956 was exhausted by the distribution of $20.

Amount taxable to DC in 1996

• Under IRC 956 (the lesser of A or B)	$15
• Subpart F income	5
Total	$20

Continued on next page

Read

- IRC § 951(a)(1)(B) – Amount Included in Gross Income of U.S. Shareholder
- IRC § 956(a) – Investment of Earnings in U.S .Property – General Rule
- IRC § 956(b)(1) – Applicable Earnings

Exclusion of Investment of Subpart F Income

Exclusion of Previously Taxed Income

IRC § 959(a)(2)

- The E&P of a CFC which was previously taxed to a U.S. shareholder as Subpart F income is not taxable again to the shareholder if it is invested in U.S. property.
- For example, a CFC has $1,000,000 in Subpart F income and lends the entire amount to its U.S. parent. The $1,000,000 is taxable to the U.S. shareholder as Subpart F income. Although, the loan to the parent is an investment in U.S. property and normally would be taxable to the U.S. parent under IRC § 956, it is excluded from such taxation because it was already taxed once as Subpart F income.
- IRC § 959(a)(2) says in effect that Subpart F income may be invested in U.S. property without taxing it a second time to the U.S. shareholder.

Ordering Rules of IRC § 959(c)

- We know that under IRC § 959(a) (2) E&P of a CFC which was previously taxed to a U.S. shareholder is not taxed again when it is invested in U.S. property. The question arises, when a CFC makes an investment in U.S. property which of its earnings is it investing?
- This question is answered by IRC § 959(c) and Treas. Reg. § 1.959-1(c) favoring the taxpayer.
- The regulations state "The first amounts deemed invested in U.S. property are amounts previously included in the gross income a U.S. shareholder under IRC § 951(a) (1) (A)."

Continued on next page

Example 50

Treas. Reg. § 1.959-1(c) Examples (a) and (b)

DC a domestic corporation owns 100 percent of CFC.

- In 1994 CFC has Subpart F income of $35 which is includible in DC's gross income (U.S. shareholder) in 1994 under IRC § 951(a) (1) (A).
- In 1994 CFC invests $50 in U.S. property.
- CFC does not make any distributions in 1994.
- CFC has E&P of over $50.

How much is includible in DC's gross income in 1994 as a IRC § 956 amount?

Only $15 of the $50 invested in U.S. property in 1994 is includible in DC's gross income under IRC 951(a) (1) (B).

$35 is includible in DC's gross income as Subpart F income and, therefore, may be invested in U.S. property without again being included in DC's gross income.

Continued on next page

Example 51

Treas. Reg. § 1,959-1(c) Example (c)

DC a domestic corporation owns 100 percent of CFC.

- In 1993 CFC has Subpart F income of $35 which is includible in the gross income of DC (U.S. shareholder) in 1993 under IRC § 951(a) (1) (A).
- CFC has E&P of over $35 in 1993.
- In 1994 CFC invests $50 in U.S. property.
- CFC does not make any distributions in 1993 and 1994.
- CFC has E&P of over $50 in 1994.

How much is taxable in 1994 to DC as investment in U.S. property?

Of the $50 investment of earnings in U.S. property made by CFC in 1994, $35 is excluded from DC's gross income for 1994 under IRC § 959(a)(2) because such amount represents E&P attributable to amounts which have been included in DC's income in 1993 under IRC § 951(a)(1)(A)(i).

The remaining $15 is includible in DC's gross income for 1994 as investment of earnings in U.S. property under IRC § 951(a) (1) (B).

Read

- IRC § 959(a)(2) – Exclusion from Gross Income of Previously Taxed E&P
- IRC § 959(c) – Allocation of Distributions
- Treas. Reg. § 1.959-1(c) – Excludable Investment of Earnings in U.S. Property

Rulings and Issues

Introduction

On the following pages, you will read about decisions which have an effect on this issue, and descriptions of certain cases. These are presented to expose you to some of the situations you might encounter during your examinations. As you read, consider different ways you might develop similar facts in your own cases.

Back-to-Back Loans

A CFC makes a bank deposit into an unrelated bank. The bank lends funds to the domestic parent. Both the bank and the CFC are located in Country Y. The income tax convention in effect between the U.S. and Country Y precludes taxing interest paid by a U.S. person to a resident of Country Y. During the term of the loan, the CFC's deposit always exceeded the balance due the bank from the U.S. parent. The interest spread between the loan and the deposit was less than one percentage point. The interest rate charged by the bank on the loan to the domestic parent would have differed absent the deposit by the CFC in the bank.

Issues

1. Are the deposits independent transactions?
2. Would the loan have been made or maintained on the same terms regardless of the deposit?

Ruling

Rev. Rul. 87-89 held that because the loan was not an independent transaction and would not have been made or maintained on the same terms without the corresponding deposit, the transaction is recharacterized as a direct loan from the CFC to the U.S. parent. Accordingly, the loan is considered U.S. property.

Continued on next page

Investment Through Partnerships

Treas. Reg. § 1.956- 2(a)(3)

A CFC has a 25 percent interest in the capital and profits of a partnership. In 1990, the partnership purchased undeveloped land in the United States. The land is not subject to any mortgages or other liabilities.

Issue

Does the CFC hold U.S. property, within the meaning of IRC § 956, when it is a partner in a partnership that owns real property located in the U.S.?

Ruling

This issue was originally dealt with in Rev. Rul. 90-112 which holds that the CFC is considered to hold a 25 percent interest in the land, on the last day of its 1990 taxable year. Final Regulations (Brown Shoe Regs) were issued on July 23, 2002 which upholds Rev. Rul. 90-112, 1990-2 C.B. 186. The final Regulations state that if a CFC is a partner in a partnership that owns property that would be United States property, if owned directly by the CFC, then the CFC will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as an interest in U. S. property. This rule applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

Continued on next page

Affirmative Use of IRC § 956

Fact Pattern

- An unrelated lender makes a loan to a U.S. corporation.
- The collateral for the loan is the stock of the U.S. borrower's CFC, or else the loan is guaranteed by the CFC.
- The collateral, or guarantee, was not requested by the lender, and the loan would have been made on the same terms without the collateral or guarantee.
- The U.S. borrower has claimed IRC § 960 foreign tax credits, as a result of the Subpart F inclusion. Under the above facts, the loan results in an investment in U.S. property by the CFC, under IRC § 956.

Issue

May a taxpayer intentionally use IRC § 956 as a means of repatriating the earnings of a CFC, and thus obtain an indirect foreign tax credit without actually paying a dividend?

Position

Each such case must stand on its own merits. There is nothing to prevent the taxpayer from using the provisions of IRC § 956 for his own benefit. However, as in all issues, the agent must verify that the facts presented by the taxpayer are correct, and that the provisions of the Code and regulations are followed correctly.

The Limited, Inc. v. CIR, 113 TC 169 (1999), rev'd, 286 F.3d 324

Fining of Circuit Court

The Sixth Circuit, reversing the Tax Court, has held that certificates of deposit bought by a foreign subsidiary of The Limited, Inc. from a subsidiary were not investments in U.S. property and are deposits with persons carrying on **the banking business** (IRC § 956 (c)(2)(A)).

Facts

- The Limited, Inc. is one of the largest U.S. specialty retailers.
- In 1989, Limited, Inc. formed the World Financial Network National Bank (WFNNB) to engage only in credit card operations.
- WFNNB entered into agreements with Limited Inc.'s stores regarding credit cards to be issued by WFNNB with the stores' names and logos.
- To satisfy WFNNB's cash needs it obtained a line of credit from another Limited, Inc. subsidiary, Limited Service Corp. (Limited Service).
- In January 1993, fourth-tier subsidiary MFE (Netherlands Antilles) N.V. (MFE N.V.) purchased eight CDs from WFNNB in the total amount of US $174.9 million.
- WFNNB transferred the US $174.9 million to Limited Service to reduce the balance outstanding on its line of credit. MFE N.V., which had no employees, was organized to engage in group financing activities.

IRS Argument

- The IRS determined that the $174.9 million used by MFE N.V. to purchase the CDs represented an "increase in earnings invested in United States property," taxable under IRC § 951.
- The Commissioner argues that the definition of "bank" in IRC § 581 controls here and excludes WFNNB as "a person carrying on the banking business." The Commissioner relies upon Revenue Ruling 70-385, which applied the § 581 definition of "bank" to § 956© (2) (A) exceptions in the context of foreign banks. See Rev Rul. 70-385, 1970-2 C.B. 156.

Continued on next page

The Limited, Inc. v. CIR, 113 TC 169 (1999), rev'd, 286 F.3d 324, Continued

Taxpayer Argument

Limited, Inc. argued that the MFE N.V. CDs are excepted from the definition of U.S. property because they are "deposits with persons carrying on the banking business" under IRC § 956(c) (2) (A).

Tax Court Ruling

- The U.S. Tax Court sustained the IRS's determination.
- The Tax Court said the question was not whether WFNNB was a bank, but whether it was "in the business of banking."
- The court said that IRC § 956 provides an exception for deposits with persons carrying on the banking business.
- The court reasoned that IRC § 956 does not provide an exception for deposits with "banks," but rather for "deposits with persons carrying on the banking business."
- The court dismissed The Limited's argument that since WFNNB was a bank it was necessarily carrying on a banking business.
- The court also held that the MFE N.V. CDs were attributable to its parent, Mast Industries (Far East) Inc. (MFE).
- The purchase of the CDs was a repatriation of MFE's earnings; and that the repatriation should be a dividend from MFE to Limited, Inc.
- Under Temporary Regulations § 1.956-1T (b) (4), the IRS could attribute the CDs to MFE.

Continued on next page

Circuit Court Ruling

- The Commissioner argues that the definition of "bank" in I.R.C. § 581 controls here and excludes WFNNB as "a person carrying on the banking business."
- The Commissioner relies upon Revenue Ruling 70-385, which applied the § 581 definition of "bank" to § 956(b) (2) (A) exceptions in the context of foreign banks.
  See Rev. Rul. 70-385, 1970-2 C.B. 156.
- The Commissioner's argument is incorrect for three reasons:

  1. there is no statutory basis for applying the § 581 definition of "bank" to the § 956(b)(2)(A) exception;
  2. Revenue Ruling 70-385 is not binding on this Court and is at best persuasive authority; and
  3. given its scope, Revenue Ruling 70-385 does not apply here.

- The Circuit Court dismissed the argument that WFNNB isn't a bank under IRC § 956. The court, construing undefined terms in accordance with their ordinary meaning, considered the term "banking."
- The Circuit Court rejected the IRS's argument that the CDs weren't deposits under the meaning of the phrase "deposits with persons carrying on the banking business."

IRS Response to Circuit Court Loss

The problem encountered in The Limited has been resolved with the enactment of American Jobs Creation Act of 2004 – Act Section 837.

The new provision defines "banking business" for purposes of the exception from the definition of U.S. property for deposits with persons carrying on a banking business. The type of entity in *The Limited* would not qualify for this exception.

Examination Techniques

CAS Applications

Discuss this issue with your Computer Audit Specialist to see if he or she can run an application which gives intercompany loan balances for each CFC.

CFC in High Tax Rate Country

Look to see whether the CFC is paying a rate of tax higher than U.S. rates. It is possible that the deemed paid foreign tax credits generated by an IRC § 956 adjustment might be greater than the U.S. tax increase. If this situation exists, you might elect to not examine that CFC, with regard to IRC § 956.

E&P

The CFC must have positive E&P to generate income to the U.S. shareholder under IRC § 956. Remember that E&P must be based on U.S. standards. You may be able to increase the E&P from a negative to a positive amount by applying U.S. standards.

If the CFC has significant E&P, determine how these assets are being used. Excess funds are seldom left in the bank. If the balance sheet indicates a large bank balance, those funds may be used to secure loans of the U.S. shareholder.

Loans to U.S. Shareholders

Loans to U.S. affiliates are often reflected on the balance sheet under other assets, such as advances, intercompany receivables or payables, etc. They are also sometimes shown as negative liabilities.

- If a CFC with no E&P has made large loans to U.S. affiliates, determine where the funds came from.
- You may find a loan from a profitable CFC. Some taxpayers use this approach to repatriate funds, while skirting the IRC § 956 issue.

Continued on next page

Investments Held on Behalf of a CFC

Temporary Reg. § 1.956-1T(b)(4)

- A CFC will be considered to hold indirectly the investments in U.S. property which are held on its behalf by a trustee or U.S. nominee or by any other controlled foreign subsidiary if the purpose is to avoid the application of 956.
- Temporary regulation § 1.956-1T(b)(4) provides that a CFC indirectly holds investments in “United States property” where one of its subsidiaries makes investments in “United States property” and one of the principal purposes for creating, organizing, or funding the subsidiary was to avoid the application of § 956.

Summary

In General

In general, the amount taxable as IRC § 956 income is the lesser of two amounts:

1. The first amount is the excess of:

    a) A U.S. shareholder's pro rata share of the quarterly average amount of U.S property held by a CFC,

    OVER

    b) E&P described in 959(c)(1)(A), (E&P already taxed to the U.S. shareholder on account of investment in U.S. property)

    OR

2. A shareholder's pro rata share of the "applicable earnings" of the CFC.

Theory of IRC § 956

The theory behind IRC § 956 is to tax earnings brought back to the United States that are substantially equivalent to a dividend.

U.S. Property

U.S. property includes, in general:

- Tangible (personal or real) property located in the United States;
- Stock of a domestic corporation;
- Any obligation of a U.S. person, including any obligation that the CFC is deemed to hold by reason of its being a pledger or guarantor of such obligation;
- Any right to the use in the United States of a patent, copyright, invention, model, design, secret formula or process, or any other similar right, if the right to such use is acquired or developed by the CFC for use in the United States.

Continued on next page

Form 5471

The Form 5471 needs to be thoroughly analyzed for types of transactions, and the E&P correctly determined, before income can be taxed to the U.S. shareholder under IRC § 956.

Problems

Compute the amount to be reported by the U.S. shareholder as taxable under IRC § 956 in each year:

Assume that the U.S. shareholder owns 100 percent of the CFC in each year.

1. 1994 – CFC has current E&P of $500 and no accumulated E&P. CFC makes an investment in U.S. property of $100 (none of it is Subpart F income).
2. 1995 – CFC has current E&P of $400. CFC makes an additional investment in U.S. property of $300 for a total of $400.
3. 1996 – CFC has a current deficit in E&P of ($1100). CFC makes an additional investment in U.S. property of $200 for a total of $600.

Audit Guide

Subpart F Income: IRC §§ 951-958

Subpart F is primarily directed at two types of income: passive investment income and income derived from related parties in no/low tax countries. Congress enacted Subpart F provisions to discourage U.S. taxpayers from using foreign corporations to defer US taxes by accumulating certain types of income in foreign base companies located in no or low tax countries (tax haven countries). Subpart F imposes immediate taxation on this tainted income even if not brought back into the USA.

Subpart F income consists of income that is easily movable to a low-tax jurisdiction:

- Insurance Income (IRC § 953)
- Foreign base company income (IRC § 954)
- Boycott income (IRC § 999)
- Illegal bribes, kickbacks and other payments (IRC § 162(c))
- Income from certain blacklisted countries (IRC § 901(j))
- Foreign personal holding company income (IRC § 954(a))

The most important category is foreign base company income. CFCs are created in order to isolate some of the parent's active trade/business income in a low tax country. The goal is to have the CFC earn most of the income and the US parent to incur most of the expenses. IRC 482 allows IRS to reallocate income and expenses between a parent and subsidiary, but the subpart F provisions offer a more potent weapon which can apply even if all transactions are at "arm's length". Section 482 allocations can be very difficult to determine and even more difficult to sustain.

Subpart F currently taxes Controlled Foreign Corporation (CFC) income via a "deemed dividend".

Continued on next page

A CFC is defined as a foreign corporation owned more than 50% by US shareholders (IRC § 957). A US shareholder is a US person with at least 10% voting power (IRC § 951(b)). In determining CFC status, look to the rules contained in IRC § 957(a) and IRC § 958 for direct, indirect and constructive ownership. A taxpayer's pro rata share of subpart F income is based on direct and indirect (but not constructive) ownership. The shareholder is treated as if a dividend was received and then contributed back to the corporation, thereby increasing the shareholder's stock basis (IRC § 961). A subsequent distribution of previously taxed income (PTI) is not further taxed and the stock basis is reduced (IRC § 959). Deemed dividends may carry an indirect foreign tax credit (IRC § 960).

Active business operations conducted by a foreign corporation are not generally affected by the subpart F provisions. Subpart F is not income effectively connected with a US trade or business (952(b)). If subpart F taxes the shareholder, then there is no accumulated earnings tax because the corporation was not used to avoid the shareholder-level taxes. Subpart F is limited to current earnings and profit (IRC § 952(c).

A U.S. corporation operating through a foreign subsidiary is not immediately taxed on the subsidiary's income, and does not have a creditable foreign tax credit until the income is distributed back to the US parent as a dividend. If the foreign subsidiary is also a controlled foreign corporation (CFC) which has subpart F income taxable immediately to the US shareholder; foreign taxes paid on this income may qualify for the foreign tax credit. A US corporation operating through a foreign branch recognizes income as it is earned and can credit foreign taxes paid on this income (IRC § 901).

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IRC § 954, foreign base company income will be the greatest area of concern on the type of cases we examine. FBCI is the sum of a CFC's:

- Foreign personal holding company income.
- Foreign base company sales income.
- Foreign base company services income.
- Foreign base company shipping income.
- Foreign base company oil-related income.

FPHCI consists of passive income such as interest, dividends, rents, royalties, commodities transactions, foreign currency gains, etc. There are some exceptions related to the business needs exceptions. You will need to gather additional facts from the taxpayer and research IRC § 954(c) and (d).

FBC sales and services income as well as any type of passive income earned by a CFC based in a tax haven country should raise questions such as the following:

1. Why are they doing business in that location when the economic activity is outside the country of incorporation?
2. What resources are available, such as natural resources, qualified personnel, and modern communications systems?
3. What transportation systems are available for transporting goods or people?
4. Where is their market? Is it in country or is it elsewhere?
5. Are they actually producing the goods or service in country?
6. What did they have to do to be licensed by the country government officials in order to conduct business in country?
7. Does it make sense to you that they are carrying on this business in a location that may be remote from their customers?

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Look behind the books to the real character of the earnings. In some situations goods are manufactured in one foreign country, and re-invoiced in another. This is an effective method of manipulating cost of goods sold. Why is the documentation produced in Country B if the factory is located in Country A? Again, this is just one possible area of abuse.

Example 60

US shareholder is a commissioned sales representative doing business as a U.S. corporation. He determines that a U.S. manufacturer needs a particular part that a Korean company produces. He is paid a commission on every part purchased by the U.S. customer. He set up a Cayman Island company with the identical name as his U.S. based company, and instructed the U.S. customer to make all payments to the Cayman Island company. The services were performed outside the country of incorporation, and therefore taxable under subpart F. (The taxpayer was convicted for fraud).

In addition, look for:

- Performance of services income versus royalty income
- If payment is for services, how was the payment structured?
- Guaranteed income or profit may actually be a payment for services.
- Was the payment made to a related party?
- Again, where did performance actually occur?

Economic substance:

- Was there a true ownership interest held by the CFC?
- What are the specific rights granted in the contract?
- Who actually bears the benefits and burdens of ownership?
- Who bears the financial risk (watch for non-recourse financing)?
- Be aware that creative license granted in the contract does not equal ownership. This is a negotiated issue in the contract.
- Was assistance furnished by a related party including direction, supervision, services or know-how?

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Example 61

U.S. shareholder, Singer A, plans a world-wide tour and sets up a foreign corporation located in the Cayman Islands. The Cayman company contracts his services for $50,000. The world-wide tour actually earns $500,000, of which $450,000 now resides on the Cayman Company books. This $450,000 income is considered tainted and is immediately taxable to Singer A under subpart F. (Singer A can claim creditable foreign taxes paid on the income).

Glossary of Terms

Abbreviations

AFR	Applicable Federal Rate
CFC	Controlled Foreign Corporation
CPM	Comparable Profits Method. See Treas. Reg. § 1.482-5. Note that although “Cost Plus Method” has the initials, “CPM” is usually used to refer to Comparable Profits.
COIC	Captive Offshore Insurance Company
CUP	Comparable Uncontrolled Price Method. See Treas. Reg. § 1.482-3(b).
CUT	Comparable Uncontrolled Transaction. See Treas. Reg. § 1.482-4(c).
DASTM	Dollar Approximate Separate Transaction Method for functional currency. See Treas. Reg. § 1.985-3.
DISC	Domestic International Sales Corporation
DRC	Dual Resident Corporation
E&P	Earnings and Profits

Continued on next page

Abbreviations, Continued

ECI	Effectively Connected Income
ETI	Extraterritorial Income
ETIE	Extraterritorial Income Exclusion
FASB	Financial Accounting Standards Board
FBC	Foreign Base Company
FBCI	Foreign Base Company Income
FBCSI	Foreign Base Company Sales Income
FCC	Foreign Controlled Corporation
FDIP	Foreign Direct Investment Program
FDR	Formal Document Request
FIRPTA	Foreign Investment in Real Property Tax Act
FOGEI	Foreign Oil and Gas Extraction Income

Continued on next page

Abbreviations, Continued

FORI	Foreign Oil-Related Income
EPHC	Foreign Personal Holding Company
FPHCI	Foreign Personal Holding Company Income
FSC	Foreign Sales Corporation
FTC	Foreign Tax Credit
GAAP	Generally Accepted Accounting Principles
GATT	General Agreement on Tariffs and Trade
IC-DISC	Interest Charge Domestic International Sales Corporation
NRA	Non-Resident Alien
OECD	Organization for Economic Cooperation and Development
OID	Original Issue Discount
PFIC	Passive Foreign Investment Company

Continued on next page

Abbreviations, Continued

QBU	Qualified Business Unit
QEF	Qualified Electing Fund
RPM	Resale Price Method. See Treas. Reg. § 1.482-3(c).
USRPI	U.S. Real Property Interest

Definitions

Additional E&P Amount	The additional E&P amount is the pre-1963 E&P (or deficit) attributable under the principles of IRC §1248, to the stock of a foreign corporation that is exchanged. This amount does not include E&P (or deficits) of lower-tier subsidiaries.
Affiliated Group	An affiliated group is defined in IRC §1504 as generally, one or more chains of corporations connected, through stock ownership, with a common parent.
Allocation	Allocation is the process of directly charging a deduction to a class of gross income to which it is definitely related. Allocation is the first step in what is generally a two-step process. (See apportionment)
Applicable Federal Rate	Federal short-term rate, Federal mid-term rate, or Federal long-term rate. The three Federal rates are calculated monthly by the Service and are published in the Internal Revenue Bulletin as a Revenue Ruling. The published rates apply for transactions occurring during that month. Each month's Cumulative Bulletin contains the AFRs stated for equivalent annual, semiannual, quarterly, and monthly compounding periods.
Apportionment	Apportionment is the second step in a two-step process. After allocation, deductions must be apportioned, within the class of gross income, between the statutory grouping and the residual grouping. (See allocation)

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Appropriate Exchange Rate

The appropriate exchange rate is for:

- actual distributions of E&P, the spot rate on the date the distribution is included in income.
- an actual sale (or deemed sale) or exchange of stock in a foreign corporation, treated as a dividend under IRC §1248, the spot rate on the date the deemed dividend is included in income.
- any amounts included in income under IRC §§ 951(a)(1)(A) or 1293(a), the weighted average exchange rate for the taxable year of the foreign corporation, or
- any other QBU of a taxpayer, the weighted average exchange rate for the taxable year of the QBU.

Bearer Shares

Bearer shares are unregistered stock shares that are owned by anyone holding them at the time.

Best Method Rule

When applying the provisions of IRC § 482, under the Best Method Rule, Treas. Reg. § 1.482-1(c), a taxpayer, in providing evidence of the appropriateness of the results of pricing policies for controlled transactions, must select the pricing method that will provide the “most reliable measure” of an arm’s length result.

Booking Date

The booking date with respect to transactions in nonfunctional currency (IRC § 988 transactions), is the date on which the taxpayer does one of the following:

- acquires a debt instrument,
- becomes an obligor (debtor),
- accrues an item of expense, or
- accrues an item of gross income.

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Class of Gross Income

A <u>class of gross income</u> is the gross income to which a specific deduction is definitely related. The class of income may consist of one or more items of gross income enumerated in IRC § 61. The classes of gross income are not predetermined, but must be determined on the basis of the deductions to be allocated.
(Treas. Reg. § 1.861-8(a)(3)).

Control

<u>Control</u> is:

- a stockholder owning stock with more than 50 percent of the voting power of all classes of stock entitled to vote, or owns more than 50 percent of the total value of all shares of stock in the foreign corporation,
- defined in IRC §1441(a), and
- the term includes control, receipt, custody, disposal, or payment.

Controlled Foreign Corporation

A <u>controlled foreign corporation</u>, as defined in IRC § 957(a), is any foreign corporation whose U.S. shareholder(s) satisfy one of the following conditions on any day during the taxable year of such foreign corporation:

- own more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote,
- own, directly or indirectly, more than 50 percent of the total value of the stock of such corporation (see IRC § 958(a)), or
- constructively own more than 50 percent of the stock in such corporation, as stated in IRC § 958(b).

Correlative Adjustments

<u>Correlative adjustments</u> are reciprocal adjustments, created as a result of other adjustments, usually having the opposite effect of the original adjustment. For example, interest income to one party creates additional interest expense to the other party.

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Deductions

A <u>deduction</u> to be allocated can include expenses, losses, and other items. The deductions which are to be allocated can be divided into three groups:

- a deduction definitely related to a class of gross income (Treas. Reg. § 1.861-8(b)(4)),
- a deduction definitely related to all gross income (Treas. Reg. § 1.861 8(b)(5)), and
- a deduction not definitely related to any gross income (Treas. Reg. § 1.861-8(c) (3)).

A deduction shall be considered definitely related to a class of gross income and, therefore, allocable to such class, if it is incurred as a result of, or incidental to, an activity or in connection with property.

Deemed Paid Credit

A <u>deemed paid credit</u> is foreign tax credit claimed on repatriated E&P from which foreign income taxes have been paid. The credit is usually associated with dividends from a CFC, Subpart F income, and IRC § 1248 dividends.

Direct Credit

A <u>direct credit</u> is foreign tax credit claimed on foreign income taxes which were paid directly by the company claiming the credit. This credit usually is from the taxes directly withheld by the foreign payor, foreign branches, or U.S. subsidiaries doing business abroad.

Disregarded Entity

A <u>disregarded entity</u> is an entity that is disregarded as an entity separate from its owner. If owned by a partnership or corporation, it is treated as a division or branch of the owner. If owned by an individual, it is treated as a sole proprietorship.

Dollar Approximate Separate Transaction Method

See “U.S. Dollar Approximate Separate Transaction Method”.

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Dual Capacity Taxpayer

A dual capacity taxpayer is a person who receives a specific economic benefit from a foreign government, and pays a tax to the country providing the benefit.

Dual Resident Corporation

A domestic corporation or a separate unit of a domestic corporation that:

- is subject to U.S. taxation, and
- is also subject to income tax of a foreign country on its worldwide income or as a resident.

Effectively Connected Income

Effectively connected income is normally associated with a U.S. trade or business. A U.S. trade or business is not defined in the Code or Regulations. Treas. Reg. §§ 1.864-2 through 1.864-8T help to define U.S. trade or business, and effectively connected income. This term refers to the requirement that non-resident alien individuals and foreign corporations, trusts, or estates that are shareholders in a DISC, will treat the following items as effectively connected with the conduct of a trade or business:

- gains on the disposition of DISC stock,
- deemed distributions, or
- distributions out of accumulated DISC income.

Equity Kicker

An equity kicker is a loan in which the creditor has a right (direct or indirect) to share in the value or net proceeds or profits of an interest in real property.

Exchange Gain or Loss

An exchange gain or loss is used in Treas. Reg. § 1.988-2 to refer to foreign currency gain, or foreign currency loss.

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Export Gross Receipts

Export gross receipts are all qualified export receipts described in IRC § 993(a)(1)(A),(B),(C),(G), and (H), reduced by 50 percent of the qualified export receipts attributable to military property, as defined in IRC § 995(b)(3)(B).

Export-Import Bank Obligation

An export-import bank obligation is, within the qualified export assets classification scheme, an obligation issued, guaranteed, insured, or reinsured, either completely or partially, by the export-import banks of the United States, or by the Foreign Credit Insurance Association.

FASB 52

FASB 52 is a statement of the Financial Accounting Standards Board which governs the translation and handling of foreign currency transactions for financial accounting purposes.

Financing Obligations

Financing obligations are any obligations of a domestic corporation organized solely for the purpose of financing sales of export property, pursuant to an agreement with the Export-Import Bank under which such corporation makes export loans guaranteed by that bank.

Foreign Controlled Corporation

The term "foreign controlled corporation" (FCC) is not defined in the Internal Revenue Code. Generally, an FCC is a U.S. corporation or a U.S. branch that is owned more than 50 percent, directly or indirectly, by a foreign person or foreign persons.

Foreign Currency Gain or Loss

Foreign currency gain or loss is gain or loss from transactions in nonfunctional currencies (IRC § 988 transactions), to the extent attributable to changes in exchange rates during the period after the booking date, and before the payment date.

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Foreign Investment in Real Property Tax Act

The Foreign Investment in Real Property Tax Act is the Foreign Investment in Real Property Tax Act of 1980, which enacted IRC § 897. The intent of FIRPTA is to tax a foreign person's gains on disposition of interests in U.S. real property.

Foreign Oil and Gas Extraction Income

Foreign oil and gas extraction income is foreign source taxable income from:

- the extraction of minerals from oil or gas wells located outside the United States and its possessions,
- sales and exchanges of assets used in the business of extracting these
- minerals, or
- minerals include hydrocarbon minerals extracted from oil and gas wells, including:
  - crude oil,
  - natural gas,
  - incidental impurities from these wells, such as sulfur, nitrogen, or helium.

Minerals from shale oil and tar sands, however, are excluded.

Foreign Oil Related Income

Foreign oil-related income is income from purchases and sales of oil and gas. The term also includes income from oil and gas, subsequent to the extraction phase.

Format Document Request

A document request issued under the provisions of IRC § 982. Failure to produce records requested in a Formal Document Request can prohibit the introduction of those documents to a court.

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Forward Contract

A forward contract is, in general, a private contract to buy or sell a commodity at some time in the future. For purposes of IRC § 988, the commodity is a nonfunctional currency. Such a contract must be marked to market at the end of the tax year, unless it meets one of the following definitions:

- hedging transaction, per IRC § 1256(e)(2), or
- hedging transaction, per IRC § 988(d).

Functional Currency

Functional currency is the currency in which generally all income tax determinations of a taxpayer are made. The U.S. dollar is the functional currency, except in the case of a QBU for which a foreign functional currency is permitted.

Futures Contract

A futures contract is, in general, a contract entered into on a futures exchange, to buy or sell a commodity at some time in the future. For purposes of IRC § 988, the commodity is a nonfunctional currency. Such a contract must be marked to market at the end of the tax year, unless it meets one of the following definitions:

- hedging transaction, per IRC § 1256(e)(2), or
- hedging transaction, per IRC § 988(d).

Green Card Test

The green card test is the same as the Lawful Permanent Resident Test. See below.

Hedged Executory Contract

A hedged executory contract is a contract entered into, but not yet completed. As of yet, no amounts are payable or receivable under the contract. Such a contract specifies a nonfunctional currency, combined with a hedge against fluctuations in the dollar value of that currency. If all the requirements of the Regulations are met, no exchange gain or loss is recognized on the hedged portion of a hedged executory contract.

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Hedging Transaction

A hedging transaction is, in general, a taxpayer's sale or purchase of a foreign currency forward, in order to protect against fluctuations in the value of a foreign currency, in which the taxpayer has invested or owes a debt. Hedging transactions are, in general, required to be marked to market at the end of the tax year, unless they meet the specifications provided in IRC §1256(e), or qualify § 988(d) hedging transactions.

Hedging transactions are generally considered to be straddles subject to the provisions of IRC §1092, unless they qualify as hedging transactions per IRC § 988(d).

Hyper-inflationary Currency

A hyperinflationary currency is the currency of a country in which there is cumulative inflation of at least 100 percent during 36 months prior to the end of the preceding tax year.

Indirect Credit

An indirect credit is the same as the Deemed Paid Credit. See above.

Intangible

As defined in Treas. Reg. § 1.482-4, an intangible is an asset that comprises any one of these six classes of items and has substantial value independent of the services of any individual:

- Patents, inventions, formulae, processes, designs, patterns, or know-how;
- Copyrights, and literary, musical, or artistic compositions;
- Trademark, trade names, or branch names;
- Franchises, license, or contracts;
- Methods, program, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Other similar items to those listed above. It is considered similar if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

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Lawful Permanent Resident Test	The lawful permanent resident test is also known as the green card test. An alien holding a green card in a permanent resident. Although the cards may no longer be green, the name has remained. See IRC §§ 7701(a) (30) and 7701(b) (6).
Mark to Market	Mark to market is recognition of gain or loss on a forward contract, or a futures contract, as though it were sold for its fair market value on the last day of the tax year. This process is required by IRC §1256 for forward contracts and futures contracts which do not qualify as hedging transactions.
Maquiladora	A Maquiladora is a Mexican enterprise that uses inexpensive labor to assemble, or further manufacture, components imported into Mexico which are eventually returned to the original owner for sale. "Maquiladora" literally means the share a farmer pays a miller for grinding grain and then returning it to the farmer.
Nonfunctional Currency	Nonfunctional currency is a currency of a taxpayer or a QBU, which is not the taxpayer's or QBU's functional currency. This term includes demand deposits, or time deposits, as well as currencies or coinages.
Notional Principal Contracts	Agreements containing a series of payments calculated upon a notional principal amount. Notional principal contracts are used by parties to fix, reduce, or adjust a user's exposure to interest rate or currency fluctuations. Examples of notional principal contracts are swap agreements, interest rate caps, floors, and collars. The market participants include dealers, traders, investors, and hedgers.
Operative Section	The operative section is a section of the Code which requires the determination of taxable income from specific sources or activities, and which give(s) rise to statutory groupings to which Treas. Reg. §1.861-8 applies.

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Option

An option is, generally, the right, but not the obligation, to buy or sell a commodity at some time in the future. The future transaction price is fixed on the day the contract is entered into. For purposes of IRC § 988, the commodity is a nonfunctional currency.

Outbound Transfers

Outbound transfers are transfers of property by a U.S. person to a foreign person. For purposes of IRC § 367(a), see Treas. Reg. § 1.367(a)-1T(d) for definitions of the following:

- U.S. person,
- foreign corporation,
- transfer,
- property,
- intangible property:
  - in general,
  - operating intangibles,
  - foreign goodwill, or
  - going concern value.

Overseas Private Investment Corporation

An overseas private investment corporation is the U.S. Government agency that insures foreign investments of U.S. companies.

Participating Advance

A participating advance is one on which the lender earns a:

- fixed rate of interest, or
- percentage of the appreciation of one of the following:
  - gross or net income, or
  - the cash flow from the property.

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Passive Foreign Investment Company

For taxable years beginning after December 31, 1986, a foreign corporation will be classified as a PFIC if either 75 percent or more of its gross income for the taxable year is passive, or the average percentage of its assets for the taxable year that produce passive income or are held for the production of passive income is at least 50 percent.

Payment Date

The payment date is, with respect to transactions in nonfunctional currency (IRC § 988 transactions), the date on which payment is made or received.

Permanent Establishment

Permanent establishment is defined under the individual tax treaties with which the U.S. is a treaty partner. It determines whether a resident of one country can be taxed by the other on what would otherwise be considered “effectively connected income.”

Pooled Reinsurance

Pooled reinsurance is a group of companies in the same industry form a venture that pools the risks of the shareholders. The shareholders assume a pro rata share of the pooled risks.

Previously Taxed Income

Previously taxed income is the sum of:

- previously taxed income as of the close of the immediately preceding taxable year
- the amount deemed distributed for the current year LESS:
- actual qualifying distributions, and
- any other actual distributions in the order in which they are made.

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Qualified Business Unit

A qualified business unit is a corporation, partnership, estate or trust. It may also be a set of activities of any of the above entities. The term may also be an individual, provided that:

- the activities constitute a trade or business, and
- a separate set of books and records is maintained with respect to the activities.

A trade or business, for this purpose, is defined as a unified group of activities which produce, or could produce, a profit independently of the rest of the entity's activities. A separate set of books and records must include both books of original entry and ledger accounts.

Qualified Electing Fund

A qualified electing fund is a fund under which electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.

Related Person

A related person is any person who has a relationship with a foreign corporation that is described in IRC § 267(b) and (c).

Related Person Insurance Income

Related person insurance income, as defined in IRC § 953(c), is defined as any insurance income of a foreign corporation attributable to a policy of insurance or reinsurance, with respect to which the primary insured is a domestic person who has shares in the foreign corporation, or a related corporation.

Residual Grouping of Gross Income

Residual grouping of gross income is gross income from all other sources or activities not included in the statutory grouping.

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Section 1248 Amount

The section 1248 amount is, in general, the E&P or deficit which would be attributable to the stock of a foreign corporation, if it were sold in an IRC § 1248 transaction. This amount includes the IRC § 1248 amounts of lower tier CFC's, but does not include amounts accumulated prior to 1962. In certain circumstances, this amount may only be a positive amount.

Section 1248(c) (2) Amount

The section 1248(c)(2) amount is the post-1962 E&P or deficit for all taxable years attributable, under the principles of IRC §1248, to the stock of a foreign corporation that is exchanged. This amount does not include E&P (or deficits) of lower-tier subsidiaries. In certain circumstances, this amount may only be a positive amount.

Shelf Corporation

A shelf corporation is a company, generally located in or run through a tax haven, that is a legally created corporation that has no business activities. A broker sells stock in the corporation to a client who can infuse it with assets, or superimpose a trade or business.

Spot Rate

A spot rate is a foreign exchange rate demonstrated, to the satisfaction of the Director, Field Operations to reflect a fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. Acceptable sources per Treas. Reg. §1.988-1(d)(1) of such spot rates include:

- the monthly issues of "International Financial Statistics," published by the International Monetary Fund,
- exchange rates published by the Board of Governors of the Federal Reserve System,
- exchange rates published in newspapers, financial journals and other daily financial news sources, and
- exchange rates quoted by electronic financial news services.

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Spot Rate Convention

A spot rate convention is a practice of the taxpayer used to translate, for purposes of determining exchange gain or loss over a period of no more than a month, all payables and receivables denominated in a nonfunctional currency at a single rate, such as the end of period, or the period average rate. Such a practice is allowed if certain conditions are met, per Treas. Reg. § 1.988-1(d) (3).

Statutory Grouping of Gross Income

A statutory grouping of gross income is gross income from a specific source or activity which must first be determined in order to arrive at taxable income under an operative section (Treas. Reg. § 1.861-8(a)(4)).

Straddle

A straddle is offsetting positions with respect to personal property. For example, foreign currency sold under a forward contract by a taxpayer, for the purpose of protection against a decline in the value of a foreign currency in which the taxpayer has invested. One position is the forward sale of the foreign currency. Generally, IRC § 1092 provides that the taxpayer may recognize a loss on one position, only to the extent that the loss exceeds the unrecognized gain on the offsetting position.

Subpart F Income

Subpart F income, in the case of a CFC, is the sum of:

- insurance income (IRC § 953),
- foreign base company income (IRC § 954),
- an amount equal to the product of income (other than that which is attributable to E&P of the foreign corporation included in the gross income of a U.S. person, under IRC § 951, multiplied by the boycott factor in IRC § 999),
- amounts of illegal bribes, kickbacks, or other IRC §162(c) payments paid by, or on behalf of, the corporation directly, or indirectly, to an official, employee, or agent of a government, and
- income derived from a foreign country when IRC § 901(j) applies to such foreign country.

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Substantial Presence Test

The substantial presence test is the requirement that an alien who is present in the United States for at least 183 days during the taxable year is treated as a resident. See IRC § 7701(b) (3) (A) for qualification requirements if an alien is present in the United States for less than 183 days.

Synthetic Debt Instrument

A synthetic debt instrument is a combination of debt instrument in a nonfunctional currency, and a hedging transaction that eliminates all exchange gain or loss on the debt instrument. Any net income or loss incurred under such a combination is considered to be interest income or expense.

Tainted Assets

Tainted assets are liquid and passive investment assets, on which realized gain will not be excepted from taxation, even though they are used in a trade or business. For assets not included in the active business exception of IRC § 367(a) (3) (A), see IRC §367(a) (3) (B).

Tax Haven

Tax havens are identified by certain characteristics. A tax haven will have one or more of the following:

a. *imposes little or no tax on certain transactions when compared to developed countries,*
b. *provides confidentiality of financial and commercial information,*
c. *has modern communications facilities,*
d. *has a treaty network which offers reduced tax rates on income taxable by its treaty partners.*

U.S. Dollar Approximate Separate Transaction Method

The U.S. dollar approximate separate transaction method is the method of currency translation which a QBU must use when it elects to use the dollar as its functional currency, rather than a hyperinflationary currency.

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U.S. Person

A U.S. person is any one of the following:

- U.S. citizen or resident,
- domestic partnership,
- domestic corporation, or
- any estate or trust (other than a foreign estate or trust within the meaning of IRC § 7701(a) (31)).

U.S. Possession

A U.S. possession is any of the following:

- the Commonwealth of Puerto Rico,
- American Samoa,
- Guam,
- Northern Mariana Islands, or
- the Virgin Islands.

U.S. Real Property Interest

A U.S. real property interest, as defined in IRC § 897 includes:

- any interest in real property located in the United States or the Virgin Islands, other than an interest solely as a creditor, or
- any interest in a domestic corporation, other than solely as a creditor, if 50 percent or more of its assets are USRPI's.

U.S. Shareholder

A U.S. shareholder is any U.S. person who owns (directly, indirectly, or constructively), 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote.

Weighted Average Exchange Rate

A weighted average exchange rate is, for purposes of determining the appropriate exchange rate, the weighted average exchange rate is the simple average of the daily exchange rates, excluding weekends, holidays and any other nonbusiness days for the taxable year.

Continued on next page

Withholding Agent	A withholding agent is the last person in the United States to handle funds before they are turned over to the taxpayer or the foreign agent of the taxpayer.

Foreign Financial Terms

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
account	konto, rechnungs-bericht	compte	conto	regning, konto	cuenta	rekening	konto	conta	regning, konto
alternate proxy	stellvertreter bevoll-mächtiger	suppleant	alternato	stedfortræ-der	alterno, apoderado	plaatsver-vanger, gevolmach-tigde	suppleant	suplente	stedfortred-er
annual reports	jahresber-icht	exercice	relazione sull'eserciz-io	arsberetning	infomre anual	jaaverslag	arsredovis-ning, arsberattise, arsberáttel-ge	exercicio	arsberetning
asset	aktivabest-ände, guthaben	actif	atttivo	aktiver	activo	actief	tillgångar	activo	aktiva
auditor	bücherrevis-oren	commis-saire aux comptes	revisori del conti	ravisorer	contador, revisor de cuenta	verificateur-en	revisorer	peritos de contabili-dade	revisorer
balance, remainder	bilanz	valance	bilancia	saldo	balanza, resto	balans	saldo	balança	saldo
balance sheet	bilanz	bilan	bilancio	status-apgorelse	hoja de balance	balans	balansrák-ning	balancete	status
bill of exchange	wechsel	lettre de change	lettera di cambio	veksel	letra de cambio	wissel	växel	letra de cambio	veksel
brokerage	maklerge-bühr	courtage	medlazione	mæglerge-byr	correduria	courtage	mæsæklere-arvade	corretagem	mekler-provisjon

Continued on next page

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
capital	kapital, vermögen	capital, fond social	capitale	kapital	capital	kapitaal	kapital	capital	kapital
capital and reserves	kapital und reserven	fond social patromoine	patrimonio sociale	egenkapital	capital y reservas	kapitaal en reservos	eget-kapital	capital e reservas	egenkapital
cash and deposits	kassastand u. guthaben, bargeld u. depositen	banques et caisses	cassa e depositi	kontanter, ogdeposi-tum	caja y depósitos	geld in kas en deposito's	kassa och banktiligo-dohavanden	caiza e depositos	kontanter og deposita
chairman	vorsitzender	president	presidente	formand, ordorer	presidente	voorzitter	ordförande	presidente	formann, styrat
commission	provision	commission	commis-sione, proviggione	provision	comisön	commissie	provision	comisséo	komisjon, provisjon
company	gesellschaft, kompanie	société, compagnie	società	selskab, kompagni	compania	maatschap-pli	bofaget	companhia	selskap, kompani
contingent liabilities guarantees	kontingent, beteiligungs -quote, passiva, bürgschaf-ten, sichergestel -lte gläubiger	engage-ments, garanties	obblighi eventuali, garanzie	garantier	pasivos eventuales, garantias	onvcorziene verplich-tingen, garanten	ansvarsför-bindelser	responsabil-idades contigentes	garantier
creditors	gläubiger, kreditoren	créanciers	creditore	kreditorer	acreedoras	schulye-ische	kreditoren	credores	kraditorer

Continued on next page

Foreign Financial Terms, Continued

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
current assets, working capital	betriebs-capital	réalizables å court terme, valeurs d'exploita-tion et valeurs	beni disponibili, capitale d'exercizio	driftskapital	capital de explotación	bedrijfs-kapitaal	omsátt-ningstilligå nger	ativo corrente	driftskapital
date due	verfallter-min, marfalldat-um	date d'échéance	scadenza	forfaldsdag	fecha de pago	vervaldag	förfallodag	data do ventimento	forfallsdag
debenture stock	festverzins-liche schuldver-schrelbun-gen	obligations	obbligazion i	gældsbreva	obligacion-es sin garantia	(Preferent) obligatie-capitaal	Debenture-kapital	titulo de obrigaçio	obligasjoner
debentures	schuldver-schrelbun-gen obligatione n	obligations	obbligazion i	debenturer, gældsbreva	obligacion-es	preferente obligatias	debenture-lån	obrigaçöesa mortizasvei s	debenturen, obligasjoner
debtors	schuldner, debitoren	debiteurs	debitori	skyldnera	deudores	schulden aar	fordringar	devedores	debitorer
depreciation write-off	entwertung, abschrek-bung	amortisse-ment	ammorta-mento, riduzione	afskrivning	deprecia-ción amortizar	afschrljving wegens depreciatie	avskrivning	depreciaçåo	avskrivning

Continued on next page

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
directors (board of), directorate	vorstand, vorstands-mitglieder aufsichtsrat	conseil d'adminis-tration	amministra-tori (consigli), consiglio d'amminis-trazione	direktorat	directores (junta de directores)	raad van commissaris sen, directorium	styrelse	conselho da direcçâo	avskrivning
dividend	devidende, gewinnan-teil	repartir	dividendo	dividende, udbytte	dividendo	dividend	utdeining	dividendo	utbytte
expenses, costs	unkosten, spesen, auslagen	dépenses, frais	spese, costl, dispendio	udgifter, omkost-ninger	gastos	udtgaven, kosten	kostnader	despezas, custos	utgifter, omkost-ninger
fixed assets	immobilien, festes kapital	immobilisa-tions, biens immobiliers	beni immobili	fastkapital	bienes immuebles	immobiliën	anläggnings -tiligångar	capital fixe	fast kapital
foreign exchange or currency	divises, valuten	devises, étrangéres	valuta, estera, danaro, straniero	valuta	cambio divisas	bulteniands e deviezen	valuta	cambio estrangeiro	valuta
general expenses	allgemein-kosten, allgemeine auslagen	frais généraux	esboral generali	almindelige udgifter	gastos generalas	algemane onkosten	allmánna omkost-nader	despezas gerais	generella utgifter
gross profit	bruttoge-winn	bénéfice bruta	utile lordo	gross fortejeneste	beneficio brutop	bruto winst	bruttovinst	lucro bruto	brutto fortjeneste
income	einkünfte	revenu	intruito	indtægt	ingresos	inkomen	inkomster	renda	inntekt

Continued on next page

Foreign Financial Terms, Continued

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
income tax	einkom-menstauer	impôt sur le revenu	imposta sul reddito	indtægtsska t	impuesto sobre la renta	inkomsten-belasting	inkomsts-katt	imposto de renda	inntektes-katt
interest	zinsen	intérét	interesse	renter	interés	rente	ránta	juros	rente
interest charges	zinsenge-bühren	intéréts	interesse addebitato	renteud-gifter	gastos de intereses	rentedienst	räntedebit-ering	despezas de juros	renteom-kostning
investments	kapital-anlagen	investisse-ments	investimenti	investeringe r, pange anbringelser	inversiones	investering-en	investering, placering	investimen-tos	investering-er
issue	emmission	emission	emissione	udstedelse	emisón	emissie	emission	emissáo	emisjoner
liabilities	passiva, verbindlich-kelten	passif	passivita	forpligtig-elser	passivo	passiva	ansvarsför-bindelser	passivo	passiva
limited	akteingesell-schaft	societé anonyme	società a responsta-bilita limitate	aktieselskab	sociedad anónima	naamioze vennoot-schap	aktlebolaget	sociedade anomina de responsa-bilidade limitada	aksjelskiap
Ltd.	AG	SA	S.r.L.	A/S	SA	NV	AB	Ltda.	A/S
loan stock	anselhekap-ital	emprunts	ticoli di prestito	län	obligac-iones	obligatie-kapitaal	länekapital	titulo de empréstimo	länekapital
manage-ment	direktion, dotriabs-leitung	direction	dirazione	bestyrelsen	diracción	bedrijfs-directie	ledning	adminis-traçto	bestyreise
minority interest	minoritäts-betelligung	intéréts minoritaires	interesel di monorità	minoritets-rente	interesas de minoria	minderhelds-belang	minoritets-intrassen	acionista minoritário	minoritets-interesse

Continued on next page

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
net income	netto-einkommen	revenu net	utile netto	netto indtægt	ingresos liauidos	netto inkomen	netto inkomster	renda liquida	netto inntekt
net profit	nettogewinn	bénéfice net	utile netto	netto fortjeneste	beneficio liquido	netto winst	nettovinst	produto liquido	netto fortjeneste
option	optionsrecht	option	opzione	option	opción	premieá affaire-optie	option	opçío	opsjon
ordinary share	stammaktie	action ordinaire	azione ordinaria	odrinær aktle	acción ordinaria	gawone aandelen	stamaktle	acçío ordinaria	ordinær aksje
preference share	vorzugaktle	action de priorité	azione preferenz-iale	præferance aktle	acción preferencial	preferent aandelen	preferens-aktle	acçío préferencial	preferanse aksje
recent issues	neuemmis-sion	emissions récente	emissioni recenti	nyere udstedelser	emisiones recientes	recente emissies	nyare emissioner	emissóes recentes	ny-emisjoner
reserves	reserven. rucklagen	réserves	riserve	reserver	reservas	reserves	reserver	reservas	reserver
sales	verkauf	ventes	vendite	salg	ventas	verkoop	arvåttning, försljning	vendas	salg
secretary	sekretär	secrétaire	segretario/a	projurist	secretario	secretaris	sekreterare	secretário	sekretær
securities	effekten, wertpapiere	valeurs, titres, effets	titoli, valori	kautioner	valores	effecten	borgen, såkerhet	acçöes	verdipapirer
share price	aktlenpreis, kurswert	cours des actions	prezzo azionario, prezzo di un'azlone	aktiepris	precio de las acciones	koers de aandelen	aktlenoterin g	preço da acção	aksjekurs
subsidiaries	tochter-gesellschaf-ten	fillales	sussidiarie, fillall, associate	datter-selskaber	subsidiarias	dochter-maatschapp-ijon	dotterbolag	companhias subsidiás	datterfirmer

Continued on next page

Foreign Financial Terms, Continued

English	German	French	Italian	Danish	Spanish	Dutch	Swedish	Portuguese	Norwegian
taxation	steuern	impôt	taxxazione	skat	tribuiación	belasting	beskattning	taxaçío	skatt
trade	handel	commerce	commercio	handel	somercio	handel	handel	comércio	handel
trading profit	handels-gewinn	bénéfice d'exploita-tion	proventi di gestione, utill di gestione	handels-fortjeneste	beneficios comerciales	bedrljf-swinst	handelsvins t	lucro de comércio	driftsover-skudd

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International Technical Training

Chapter 17A

Form 5471 – Information Return of U.S. Persons with Respect to Certain Foreign Corporations

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 2 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and examples
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide

Overview

Instructor Notes

This chapter presents some basic concepts related to the filing of Form 5471. At the end of the lesson, the student should come away with some basic, but important, understanding of the purpose of the form, who is required to file this form, and what to look for in the examination process.

Introduction

In this chapter, we will discuss Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*. The form and accompanying schedules are used to satisfy the reporting requirements of sections 6038 and 6046 (and related regulations), and captures transactional information between certain U.S. Persons and certain foreign corporations in which U.S. Persons have either acquired stock or already own stock.

Objective

At the end of this chapter:

- The student will be able to understand the purpose of Form 5471 and know the basics of what to look for in the examination process.

Continued on next page

Contents

This lesson covers the following topics:

Filing Requirement

Reading Assignment

IRC §6038, §6046.

4 Types of Filers

There are several categories of filers. Please refer to the form instructions in the back of the chapter for details. In this chapter, we will cover the Category 5 Filer in some depth.

Definitions of U.S. Persons

Some common definitions of U.S. persons:

1. Citizen or resident of the United States.
2. Domestic partnerships.
3. Domestic corporations.
4. An estate or trust that is not a foreign estate or trust defined in §7701(a) (31).

Certain Foreign Corporations

The “certain” foreign corporation is defined based on how it is owned by a U.S. person. Again, refer to the categories of filers in the instructions for the specifics. An in-depth discussion of all the categories of filers is beyond the scope of this lesson.

However, a foreign corporation is basically a corporation organized outside the jurisdiction of the United States.

Thus, the form is titled Information Return of U.S. Persons With Respect to Certain Foreign Corporations.

A U.S. person with reporting requirements for more than one foreign corporation must file a *separate* Form 5471 for each applicable foreign corporation.

Unlike Form 5472, a duplicate copy of Form 5471 is no longer required to be separately filed with the IRS Service Center in Philadelphia.

Common Filer – Category 5

Reading Assignment

IRC §957, §958, §318.

Category 5 includes a U.S. shareholder who owns stock in a foreign corporation that is a Controlled Foreign Corporation (CFC). The ownership has to be for an uninterrupted period of 30 days or more, and the stock is owned on the last day of the year.

Definitions of U.S. Shareholder

Any U.S. citizen, resident, domestic corporation, partnership, estate or trust that owns directly, indirectly or constructively 10% or more of the total combined voting power of the foreign corporation.

Example 17A – 1

Joe, a U.S. citizen, owns 9% of the total voting power of stocks of foreign corporation X. His wife Mary, a U.S. resident, owns 5% of the same class of stocks. Joe and Mary constructively own the stocks of the other spouse. Therefore, both Joe and Mary are considered U.S. shareholders.

Continued on next page

Definitions of U.S. Shareholder (continued)

Once the U.S. shareholder(s) are identified AND they "collectively" own more than 50% of the voting power or value of the foreign company stock, the U.S. shareholders "must" include in gross income their pro-rata share of the CFC's "subpart F" income (§951). However, income inclusion is required *only* if the U.S. person is a shareholder on the last day of the CFC's tax year. The U.S. shareholder only includes income from that portion of the year the corporation qualifies as a CFC.

Example 17A – 2

Are Joe and Mary from example 1 required to file as category 5 filers, assuming they are the only U.S. shareholders? Why or why not? Can they qualify as a different category filer? Answer: If Joe and Mary are the only shareholders, the foreign corporation would not qualify as a CFC, and therefore they would not file as a Category 5 filer. They may file as a Category 2 filer if either Joe or Mary is an officer or director of the foreign corporation, or a Category 3 filer depending on the other facts involved.

Some Key Concepts

Reading Assignment

Read IRC §§ 952, and 954.

Subpart F Income Reporting

Subpart F income was discussed extensively in another chapter. Section 952 lists several types of income as part of the Subpart F regime. One key component of Subpart F income is Foreign Based Company Sales Income (FBCSI) - §954(d). Briefly, FBCSI is income earned by a CFC from buying or selling "personal property" from or to or on behalf of a related person if the personal property is:

(i). Manufactured, produced, grown or extracted outside of the country "in which" the CFC is organized, AND

(ii). Used, consumed or disposed of outside such country.

Example 17A – 3

Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases from corporation M, a related person, articles manufactured in the United States and sells the articles to P, an unrelated person, for delivery and use in foreign country Y. Gross income of corporation A derived from the purchase and sale of the personal property is foreign base company sales income.

Schedule I of Form 5471 is used to report in U.S. dollars the U.S. shareholder's pro rata share of income from the foreign corporation reportable under subpart F and other income realized from a corporate distribution.

Continued on next page

Current Earnings & Profits

Refer to schedule H of Form 5471 and instructions. This is the foreign corporation's E & P translated to U.S. currency.

E & P is an economic concept rather than a tax concept. It reflects the amount of funds available for distribution to the shareholders. It can also be understood as the net increase or decrease in the assets of an organization resulting from its operations. As an example, tax-exempt interest is not part of taxable income, but is included in E & P because it provides funds for possible distribution. E & P is often arrived at by starting with taxable income and then adjusted by adding or subtracting items that include timing and permanent differences and economic realities.

This lesson is not designed to delve into all the intricacies of computing E & P; however, it is important to know that taxable Subpart F income is limited to positive E & P in any given year.

Example 17A – 4

Joe is a 51% U.S. shareholder in a CFC that has $100 of subpart F income in the current tax year. The CFC has a current E & P of $80. Joe needs to report $41 of subpart F income on his U.S. tax return.

Some Audit Considerations

A. Obtain financial statements translated into U.S. currency and analyze the balance sheet and P & L on form(s) 5471 indicating Subpart F income.

B. Make sure the financial statements conform to U.S. accounting standards.

C. Review the organization's bylaws, articles of incorporation, minutes, stock certificates, organization charts, etc. to determine the category of filer.

D. Ask for workpapers that support reported subpart F income, current E & P and other items that have taxation consequences.

E. Compare current Form(s) 5471 with prior and subsequent years and look for any organizations or reorganizations of foreign corporations or any stock acquisitions.

Non-Compliance Penalties

A. The initial penalty is $10,000 for failure to file, late filing or incomplete Form 5471 per form per tax period (§6038(b) (1)).
B. An additional $10,000 penalty is assessed for each 30-day period (or fraction thereof) during which the aforementioned failure continues, up to a maximum of $50,000 (§6038(b) (2)). Therefore, a total of $60,000 in monetary penalty could be assessed.
C. Foreign-tax-credit-reduction penalties could also apply under §6038(c). The amount of foreign tax credit reduction, with respect to a foreign corporation, cannot exceed the greater of $10,000 or the income of the foreign corporation for its annual accounting period when a failure to file occurs. However, the amount of the foreign tax credit reduction penalty is reduced by the amount of any dollar penalty imposed for the same period.
D. §6046(f) penalty addresses “returns as to organization or reorganization of foreign corporations & as to the acquisitions of their stock”. The dollars assessed is similar to the §6038(b) penalty and is found in §6679.
E. Reasonable cause exceptions:
   1. See Chief Counsel Advice 200748006 for guidance.
   2. A determination as to whether reasonable cause exists is based on all the facts and circumstances in each situation and relief from penalty is generally granted when the taxpayer exercised ordinary business care and prudence but was unable to comply with the filing requirements. IRM 20.1.1.3.1(1)
F. Statute of limitations on any “tax assessment” does not begin to run until the date on which the IRS is furnished with all of the required information under §6501(c) (8). However, there is no SOL on the period of assessment of the monetary penalties discussed above.

Exhibits

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Exhibit 17A – 1, *Form 5471*

Form **5471**

(Rev. December 2007)

Department of the Treasury
Internal Revenue Service

Information Return of U.S. Persons With Respect To Certain Foreign Corporations

► **See separate instructions.**

Information furnished for the foreign corporation's annual accounting period (tax year required by section 898) (see instructions) beginning , 20 , and ending , 20

OMB No. 1545-0704

Attachment Sequence No. **121**

Name of person filing this return	**A** Identifying number
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	**B** Category of filer (See instructions. Check applicable box(es)): 1 (repealed) 2 ☐ 3 ☐ 4 ☐ 5 ☐
City or town, state, and ZIP code	**C** Enter the total percentage of the foreign corporation's voting stock you owned at the end of its annual accounting period . . . . %

Filer's tax year beginning , 20 , and ending , 20

D Person(s) on whose behalf this information return is filed:

(1) Name	(2) Address	(3) Identifying number	(4) Check applicable box(es)		
			Shareholder	Officer	Director

Important: *Fill in all applicable lines and schedules. All information* **must** *be in English. All amounts* **must** *be stated in U.S. dollars unless otherwise indicated.*

1a Name and address of foreign corporation	**b** Employer identification number, if any
	c Country under whose laws incorporated

d Date of incorporation	**e** Principal place of business	**f** Principal business activity code number	**g** Principal business activity	**h** Functional currency

2 Provide the following information for the foreign corporation's accounting period stated above.

a Name, address, and identifying number of branch office or agent (if any) in the United States	**b** If a U.S. income tax return was filed, enter:	
	(i) Taxable income or (loss)	(ii) U.S. income tax paid (after all credits)

c Name and address of foreign corporation's statutory or resident agent in country of incorporation	**d** Name and address (including corporate department, if applicable) of person (or persons) with custody of the books and records of the foreign corporation, and the location of such books and records, if different

Schedule A **Stock of the Foreign Corporation**

(a) Description of each class of stock	(b) Number of shares issued and outstanding	
	(i) Beginning of annual accounting period	(ii) End of annual accounting period

For Paperwork Reduction Act Notice, see instructions. Cat. No. 49958V Form **5471** (Rev. 12-2007)

Continued on next page

Exhibit 17A – 1, *Form 5471*, Continued

Form 5471 (Rev. 12-2007) Page **2**

Schedule B **U.S. Shareholders of Foreign Corporation** (see instructions)

(a) Name, address, and identifying number of shareholder	(b) Description of each class of stock held by shareholder. **Note:** *This description should match the corresponding description entered in Schedule A, column (a).*	(c) Number of shares held at beginning of annual accounting period	(d) Number of shares held at end of annual accounting period	(e) Pro rata share of subpart F income (enter as a percentage)

Schedule C **Income Statement** (see instructions)

Important: *Report all information in functional currency in accordance with U.S. GAAP. Also, report each amount in U.S. dollars translated from functional currency (using GAAP translation rules). However, if the functional currency is the U.S. dollar, complete only the U.S. Dollars column. See instructions for special rules for DASTM corporations.*

				Functional Currency	U.S. Dollars
Income	1a	Gross receipts or sales	1a		
	b	Returns and allowances	1b		
	c	Subtract line 1b from line 1a	1c		
	2	Cost of goods sold	2		
	3	Gross profit (subtract line 2 from line 1c)	3		
	4	Dividends	4		
	5	Interest	5		
	6a	Gross rents	6a		
	b	Gross royalties and license fees	6b		
	7	Net gain or (loss) on sale of capital assets	7		
	8	Other income (attach schedule)	8		
	9	Total income (add lines 3 through 8)	9		
Deductions	10	Compensation not deducted elsewhere	10		
	11a	Rents	11a		
	b	Royalties and license fees	11b		
	12	Interest	12		
	13	Depreciation not deducted elsewhere	13		
	14	Depletion	14		
	15	Taxes (exclude provision for income, war profits, and excess profits taxes)	15		
	16	Other deductions (attach schedule—exclude provision for income, war profits, and excess profits taxes)	16		
	17	Total deductions (add lines 10 through 16)	17		
Net Income	18	Net income or (loss) before extraordinary items, prior period adjustments, and the provision for income, war profits, and excess profits taxes (subtract line 17 from line 9)	18		
	19	Extraordinary items and prior period adjustments (see instructions)	19		
	20	Provision for income, war profits, and excess profits taxes (see instructions)	20		
	21	Current year net income or (loss) per books (combine lines 18 through 20)	21		

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Continued on next page

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Schedule E **Income, War Profits, and Excess Profits Taxes Paid or Accrued** (see instructions)

(a) Name of country or U.S. possession	Amount of tax (b) In foreign currency	(c) Conversion rate	(d) In U.S. dollars
1 U.S.			
2			
3			
4			
5			
6			
7			
8 Total ▶			

Schedule F **Balance Sheet**

Important: *Report all amounts in U.S. dollars prepared and translated in accordance with U.S. GAAP. See instructions for an exception for DASTM corporations.*

Assets		(a) Beginning of annual accounting period	(b) End of annual accounting period
1 Cash	1		
2a Trade notes and accounts receivable	2a		
b Less allowance for bad debts	2b	( )	( )
3 Inventories	3		
4 Other current assets (attach schedule)	4		
5 Loans to shareholders and other related persons	5		
6 Investment in subsidiaries (attach schedule)	6		
7 Other investments (attach schedule)	7		
8a Buildings and other depreciable assets	8a		
b Less accumulated depreciation	8b	( )	( )
9a Depletable assets	9a		
b Less accumulated depletion	9b	( )	( )
10 Land (net of any amortization)	10		
11 Intangible assets:			
a Goodwill	11a		
b Organization costs	11b		
c Patents, trademarks, and other intangible assets	11c		
d Less accumulated amortization for lines 11a, b, and c	11d	( )	( )
12 Other assets (attach schedule)	12		
13 Total assets	13		
Liabilities and Shareholders' Equity			
14 Accounts payable	14		
15 Other current liabilities (attach schedule)	15		
16 Loans from shareholders and other related persons	16		
17 Other liabilities (attach schedule)	17		
18 Capital stock:			
a Preferred stock	18a		
b Common stock	18b		
19 Paid-in or capital surplus (attach reconciliation)	19		
20 Retained earnings	20		
21 Less cost of treasury stock	21	( )	( )
22 Total liabilities and shareholders' equity	22		

Form **5471** (Rev. 12-2007)

Continued on next page

Exhibit 17A – 1, *Form 5471*, Continued

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Schedule G Other Information

		Yes	No
1	During the tax year, did the foreign corporation own at least a 10% interest, directly or indirectly, in any foreign partnership? If "Yes," see the instructions for required attachment.	☐	☐
2	During the tax year, did the foreign corporation own an interest in any trust?	☐	☐
3	During the tax year, did the foreign corporation own any foreign entities that were disregarded as entities separate from their owners under Regulations sections 301.7701-2 and 301.7701-3 (see instructions)? If "Yes," you are generally required to attach Form 8858 for each entity (see instructions).	☐	☐
4	During the tax year, was the foreign corporation a participant in any cost sharing arrangement?	☐	☐
5	During the course of the tax year, did the foreign corporation become a participant in any cost sharing arrangement?	☐	☐

Schedule H Current Earnings and Profits (see instructions)

Important: *Enter the amounts on lines 1 through 5c in* ***functional*** *currency.*

		Net Additions	Net Subtractions		
1	Current year net income or (loss) per foreign books of account			1	
2	Net adjustments made to line 1 to determine current earnings and profits according to U.S. financial and tax accounting standards (see instructions):				
a	Capital gains or losses				
b	Depreciation and amortization				
c	Depletion				
d	Investment or incentive allowance				
e	Charges to statutory reserves				
f	Inventory adjustments				
g	Taxes				
h	Other (attach schedule)				
3	Total net additions				
4	Total net subtractions				
5a	Current earnings and profits (line 1 plus line 3 minus line 4)			5a	
b	DASTM gain or (loss) for foreign corporations that use DASTM (see instructions)			5b	
c	Combine lines 5a and 5b			5c	
d	Current earnings and profits in U.S. dollars (line 5c translated at the appropriate exchange rate as defined in section 989(b) and the related regulations (see instructions)). Enter exchange rate used for line 5d ▶			5d	

Schedule I Summary of Shareholder's Income From Foreign Corporation (see instructions)

1	Subpart F income (line 38b, Worksheet A in the instructions)	1	
2	Earnings invested in U.S. property (line 17, Worksheet B in the instructions)	2	
3	Previously excluded subpart F income withdrawn from qualified investments (line 6b, Worksheet C in the instructions)	3	
4	Previously excluded export trade income withdrawn from investment in export trade assets (line 7b, Worksheet D in the instructions)	4	
5	Factoring income	5	
6	Total of lines 1 through 5. Enter here and on your income tax return. See instructions.	6	
7	Dividends received (translated at spot rate on payment date under section 989(b)(1))	7	
8	Exchange gain or (loss) on a distribution of previously taxed income	8	

	Yes	No
• Was any income of the foreign corporation blocked?	☐	☐
• Did any such income become unblocked during the tax year (see section 964(b))?	☐	☐

If the answer to either question is "Yes," attach an explanation.

Form **5471** (Rev. 12-2007)

Continued on next page

SCHEDULE J
(Form 5471)
(Rev. December 2005)
Department of the Treasury
Internal Revenue Service

Accumulated Earnings and Profits (E&P) of Controlled Foreign Corporation

▶ **Attach to Form 5471. See Instructions for Form 5471.**

OMB No. 1545-0704

Name of person filing Form 5471

Identifying number

Name of foreign corporation

Important: Enter amounts in functional currency.	**(a)** Post-1986 Undistributed Earnings (post-86 section 959(c)(3) balance)	**(b)** Pre-1987 E&P Not Previously Taxed (pre-87 section 959(c)(3) balance)	**(c)** Previously Taxed E&P (see instructions) (sections 959(c)(1) and (2) balances)			**(d)** Total Section 964(a) E&P (combine columns (a), (b), and (c))
			(i) Earnings Invested in U.S. Property	(ii) Earnings Invested in Excess Passive Assets	(iii) Subpart F Income	
1 Balance at beginning of year						
2a Current year E&P						
b Current year deficit in E&P						
3 Total current and accumulated E&P not previously taxed (line 1 plus line 2a **or** line 1 minus line 2b)						
4 Amounts included under section 951(a) or reclassified under section 959(c) in current year						
5a Actual distributions or reclassifications of previously taxed E&P						
b Actual distributions of nonpreviously taxed E&P						
6a Balance of previously taxed E&P at end of year (line 1 plus line 4, minus line 5a)						
b Balance of E&P not previously taxed at end of year (line 3 minus line 4, minus line 5b)						
7 Balance at end of year. (Enter amount from line 6a or line 6b, whichever is applicable.)						

For Paperwork Reduction Act Notice, see the Instructions for Form 5471. Cat. No. 21111K **Schedule J (Form 5471)** (Rev. 12-2005)

Continued on next page

SCHEDULE M (Form 5471)
(Rev. December 2010)
Department of the Treasury
Internal Revenue Service

Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons

► Attach to Form 5471. See Instructions for Form 5471.

OMB No. 1545-0704

Name of person filing Form 5471 | Identifying number

Name of foreign corporation

Important: *Complete a* **separate** *Schedule M for each controlled foreign corporation. Enter the totals for each type of transaction that occurred during the annual accounting period between the foreign corporation and the persons listed in columns (b) through (f). All amounts must be stated in U.S. dollars translated from functional currency at the average exchange rate for the foreign corporation's tax year. See instructions.*

Enter the relevant functional currency and the exchange rate used throughout this schedule ►

(a) Transactions of foreign corporation	(b) U.S. person filing this return	(c) Any domestic corporation or partnership controlled by U.S. person filing this return	(d) Any other foreign corporation or partnership controlled by U.S. person filing this return	(e) 10% or more U.S. shareholder of controlled foreign corporation (other than the U.S. person filing this return)	(f) 10% or more U.S. shareholder of any corporation controlling the foreign corporation
1 Sales of stock in trade (inventory)					
2 Sales of tangible property other than stock in trade					
3 Sales of property rights (patents, trademarks, etc.)					
4 Platform contribution transaction payments received					
5 Cost sharing transaction payments received					
6 Compensation received for technical, managerial, engineering, construction, or like services					
7 Commissions received					
8 Rents, royalties, and license fees received					
9 Dividends received (exclude deemed distributions under subpart F and distributions of previously taxed income)					
10 Interest received					
11 Premiums received for insurance or reinsurance					
12 Add lines 1 through 11					
13 Purchases of stock in trade (inventory)					
14 Purchases of tangible property other than stock in trade					
15 Purchases of property rights (patents, trademarks, etc.)					
16 Platform contribution transaction payments paid					
17 Cost sharing transaction payments paid					
18 Compensation paid for technical, managerial, engineering, construction, or like services					
19 Commissions paid					
20 Rents, royalties, and license fees paid					
21 Dividends paid					
22 Interest paid					
23 Premiums paid for insurance or reinsurance					
24 Add lines 13 through 23					
25 Amounts borrowed (enter the maximum loan balance during the year) — see instructions					
26 Amounts loaned (enter the maximum loan balance during the year) — see instructions					

For Paperwork Reduction Act Notice, see the Instructions for Form 5471. Cat. No. 49963O **Schedule M (Form 5471)** (Rev. 12-2010)

Continued on next page

SCHEDULE O
(Form 5471)
(Rev. December 2005)
Department of the Treasury
Internal Revenue Service

Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock

► Attach to Form 5471. See instructions for Form 5471.

OMB No. 1545-0704

Name of person filing Form 5471 | Identifying number

Name of foreign corporation

Important: *Complete a* **separate** *Schedule O for each foreign corporation for which information must be reported.*

Part I — To Be Completed by U.S. Officers and Directors

(a) Name of shareholder for whom acquisition information is reported	(b) Address of shareholder	(c) Identifying number of shareholder	(d) Date of original 10% acquisition	(e) Date of additional 10% acquisition

Part II — To Be Completed by U.S. Shareholders

Note: *If this return is required because one or more shareholders became U.S. persons, attach a list showing the names of such persons and the date each became a U.S. person.*

Section A—General Shareholder Information

(a) Name, address, and identifying number of shareholder(s) filing this schedule	(b) For shareholder's latest U.S. income tax return filed, indicate:			(c) Date (if any) shareholder last filed information return under section 6046 for the foreign corporation
	(1) Type of return (enter form number)	(2) Date return filed	(3) Internal Revenue Service Center where filed	

Section B—U.S. Persons Who Are Officers or Directors of the Foreign Corporation

(a) Name of U.S. officer or director	(b) Address	(c) Social security number	(d) Check appropriate box(es)	
			Officer	Director

Section C—Acquisition of Stock

(a) Name of shareholder(s) filing this schedule	(b) Class of stock acquired	(c) Date of acquisition	(d) Method of acquisition	(e) Number of shares acquired		
				(1) Directly	(2) Indirectly	(3) Constructively

For Paperwork Reduction Act Notice, see the Instructions for Form 5471. Cat. No. 61200D **Schedule O (Form 5471)** (Rev. 12-2005)

Continued on next page

Section D—Disposition of Stock

(a) Name of shareholder disposing of stock	(b) Class of stock	(c) Date of disposition	(d) Method of disposition	(e) Number of shares disposed of		
				(1) Directly	(2) Indirectly	(3) Constructively

(f) Amount received	(g) Name and address of person to whom disposition of stock was made

Section E—Organization or Reorganization of Foreign Corporation

(a) Name and address of transferor	(b) Identifying number (if any)	(c) Date of transfer

(d) Assets transferred to foreign corporation			(e) Description of assets transferred by, or notes or securities issued by, foreign corporation
(1) Description of assets	(2) Fair market value	(3) Adjusted basis (if transferor was U.S. person)	

Section F—Additional Information

(a) If the foreign corporation or a predecessor U.S. corporation filed (or joined with a consolidated group in filing) a U.S. income tax return for any of the last 3 years, attach a statement indicating the year for which a return was filed (and, if applicable, the name of the corporation filing the consolidated return), the taxable income or loss, and the U.S. income tax paid (after all credits).

(b) List the date of any reorganization of the foreign corporation that occurred during the last 4 years while any U.S. person held 10% or more in value or vote (directly or indirectly) of the corporation's stock ▶

(c) If the foreign corporation is a member of a group constituting a chain of ownership, attach a chart, for each unit of which a shareholder owns 10% or more in value or voting power of the outstanding stock. The chart must indicate the corporation's position in the chain of ownership and the percentages of stock ownership (see instructions for an example).

Schedule O (Form 5471) (Rev. 12-2005)

Exhibit 17A – 2, *Form 5471 Instructions*

Instructions for Form 5471

(Rev. December 2009)

Department of the Treasury
Internal Revenue Service

(Use with the December 2007 revision of Form 5471 and Schedule M, and the December 2005 revision of Schedules J and O.)

Information Return of U.S. Persons With Respect to Certain Foreign Corporations

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

• The controlling U.S. shareholder(s) of a CFC may make a section 108(i) election to defer recognizing discharge of indebtedness income in certain situations. See **Section 108(i) Elections** on page 4 for additional information.

• Non-corporate U.S. shareholders are now required to report income reported on Form 5471, Schedule I, line 6 on Form 1040, line 21 (Other Income), or on the comparable line of other non-corporate tax returns.

Pending Legislation May Affect Form 5471

At the time these instructions were sent to print, legislation was pending that would extend:

• The temporary exceptions for certain "active financing income" from subpart F foreign personal holding company income, foreign base company services income, and insurance income, and

• The look-through rule of section 954(c)(6).

General Instructions

Purpose of Form

Form 5471 is used by certain U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations. The form and schedules are used to satisfy the reporting requirements of sections 6038 and 6046, and the related regulations.

Who Must File

Generally, all U.S. persons described in *Categories of Filers* below must complete the schedules, statements, and/or other information requested in the chart, *Filing Requirements for Categories of Filers*, on page 2. Read the information for each category carefully to determine which schedules, statements, and/or information apply.

If the filer is described in more than one filing category, do not duplicate information. However, complete all items that apply. For example, if you are the sole owner of a controlled foreign corporation (CFC) (i.e., you are described in Categories 4 and 5), complete all four pages of Form 5471 and separate Schedules J and M.

Note. Complete a **separate** Form 5471 and all applicable schedules for **each** applicable foreign corporation.

When and Where To File

Attach Form 5471 to your income tax return (or, if applicable, partnership or exempt organization return) and file both by the due date (including extensions) for that return.

Categories of Filers

Category 1 Filer

This filing requirement has been repealed by section 413(c)(26) of the American Jobs Creation Act of 2004, which repealed section 6035.

Category 2 Filer

This includes a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person (defined below) has acquired (in one or more transactions):

1. Stock which meets the 10% stock ownership requirement (described below) with respect to the foreign corporation or
2. An additional 10% or more (in value or voting power) of the outstanding stock of the foreign corporation.

A U.S. person has **acquired** stock in a foreign corporation when that person has an unqualified right to receive the stock, even though the stock is not actually issued. See Regulations section 1.6046-1(f)(1) for more details.

Stock ownership requirement. For purposes of Category 2 and Category 3, the stock ownership threshold is met if a U.S. person owns:

1. 10% or more of the total value of the foreign corporation's stock or
2. 10% or more of the total combined voting power of all classes of stock with voting rights.

U.S. person. For purposes of Category 2 and Category 3, a U.S. person is:

1. A citizen or resident of the United States,
2. A domestic partnership,
3. A domestic corporation, and
4. An estate or trust that is not a foreign estate or trust defined in section 7701(a)(31).

See Regulations section 1.6046-1(f)(3) for exceptions.

Category 3 Filer

This category includes:

• A U.S. person (defined above) who acquires stock in a foreign corporation which, when added to any stock owned on the date of acquisition, meets the 10% stock ownership requirement (described above) with respect to the foreign corporation;

• A U.S. person who acquires stock which, without regard to stock already owned on the date of acquisition, meets the 10% stock ownership requirement with respect to the foreign corporation;

• A person who is treated as a U.S. shareholder under section 953(c) with respect to the foreign corporation;

• A person who becomes a U.S. person while meeting the 10% stock ownership requirement with respect to the foreign corporation; or

• A U.S. person who disposes of sufficient stock in the foreign corporation to reduce his or her interest to less than the stock ownership requirement.

For more information, see section 6046 and Regulations section 1.6046-1.

Category 4 Filer

This includes a U.S. person who had control (defined below) of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.

U.S. person. For purposes of Category 4, a U.S. person is:

1. A citizen or resident of the United States;
2. A nonresident alien for whom an election is in effect under section 6013(g) to be treated as a resident of the United States;
3. An individual for whom an election is in effect under section 6013(h), relating to nonresident aliens who become residents of the United States during the tax year and are married at the close of

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Continued on next page

the tax year to a citizen or resident of the United States;

4. A domestic partnership;
5. A domestic corporation; and
6. An estate or trust that is not a foreign estate or trust defined in section 7701(a)(31).

See Regulations section 1.6038-2(d) for exceptions.

CFC

Control. A U.S. person has control of a foreign corporation if, at any time during that person's tax year, it owns stock possessing:

1. More than 50% of the total combined voting power of all classes of stock of the foreign corporation entitled to vote or
2. More than 50% of the total value of shares of all classes of stock of the foreign corporation.

A person in control of a corporation that, in turn, owns more than 50% of the combined voting power, or the value, of all classes of stock of another corporation is also treated as being in control of such other corporation.

Example. Corporation A owns 51% of the voting stock in Corporation B. Corporation B owns 51% of the voting stock in Corporation C. Corporation C owns 51% of the voting stock in Corporation D. Therefore, Corporation D is controlled by Corporation A.

For more details on "control," see Regulations sections 1.6038-2(b) and (c).

Category 5 Filer

This includes a U.S. shareholder who owns stock in a foreign corporation that is a CFC for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and who owned that stock on the last day of that year.

U.S. shareholder. For purposes of Category 5, a U.S. shareholder is a U.S. person who:

1. Owns (directly, indirectly, or constructively, within the meaning of sections 958(a) and (b)) 10% or more of the total combined voting power of all classes of voting stock of a CFC or
2. Owns (either directly or indirectly, within the meaning of section 958(a)) any stock of a CFC (as defined in sections 953(c)(1)(B) and 957(b)) that is also a captive insurance company.

U.S. person. For purposes of Category 5, a U.S. person is:

1. A citizen or resident of the United States,
2. A domestic partnership,
3. A domestic corporation, and
4. An estate or trust that is not a foreign estate or trust defined in section 7701(a)(31).

See section 957(c) for exceptions.

Filing Requirements for Categories of Filers

Required Information*	Category of Filer 1	2	3	4	5
The identifying information on page 1 of Form 5471 above Schedule A, see **Specific Instructions**		✓	✓	✓	✓
Schedule A			✓	✓	
Schedule B			✓	✓	
Schedules C, E, and F			✓	✓	
Schedule G		✓	✓	✓	✓
Schedule H				✓	✓
Schedule I				✓	✓
Separate Schedule J				✓	✓
Separate Schedule M				✓	
Separate Schedule O, Part I		✓			
Separate Schedule O, Part II			✓		

**See also Additional Filing Requirements on page 3.*

CFC. A CFC is a foreign corporation that has U.S. shareholders that own (directly, indirectly, or constructively, within the meaning of sections 958(a) and (b)) on any day of the tax year of the foreign corporation, more than 50% of:

1. The total combined voting power of all classes of its voting stock or
2. The total value of the stock of the corporation.

Exceptions From Filing

Multiple filers of same information. One person may file Form 5471 and the applicable schedules for other persons who have the same filing requirements. If you and one or more other persons are required to furnish information for the same foreign corporation for the same period, a joint information return that contains the required information may be filed with your tax return or with the tax return of any one of the other persons. For example, a U.S. person described in Category 5 may file a joint Form 5471 with a Category 4 or another Category 5 filer. However, for Category 3 filers, the required information may only be filed by another person having an equal or greater interest (measured in terms of value or voting power of the stock of the foreign corporation).

The person that files Form 5471 must complete Item D on page 1 of the form. All persons identified in Item D must attach a statement to their income tax return that includes the information described in the instructions for Item D on page 4.

Domestic corporations. Shareholders are not required to file the information checked in the chart on this page for a foreign insurance company that has elected (under section 953(d)) to be treated as a domestic corporation and has filed a U.S. income tax return for its tax year under that provision. See Rev. Proc. 2003-47, 2003-28 I.R.B. 55, for procedural rules regarding the election under section 953(d).

Members of consolidated groups. A Category 4 filer is not required to file Form 5471 for a corporation defined in section 1504(d) that files a consolidated return for the tax year.

Constructive owners.

- A U.S. person described in Category 3 or 4 does not have to file Form 5471 if **all** of the following conditions are met:

1. The U.S. person does not own a direct interest in the foreign corporation,
2. The U.S. person is required to furnish the information requested solely because of constructive ownership (as determined under Regulations section 1.6038-2(c) or 1.6046-1(i)) from another U.S. person, **and**
3. The U.S. person through which the indirect shareholder constructively owns an interest in the foreign corporation files Form 5471 to report all of the required information.

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- A Category 2 filer does not have to file Form 5471 if:

1. Immediately after a reportable stock acquisition, three or fewer U.S. persons own 95% or more in value of the outstanding stock of the foreign corporation and the U.S. person making the acquisition files a return for the acquisition as a Category 3 filer **or**
2. The U.S. person(s) for which the Category 2 filer is required to file Form 5471 does not directly own an interest in the foreign corporation but is required to furnish the information solely because of constructive stock ownership from a U.S. person and the person from whom the stock ownership is attributed furnishes all of the required information.

- A Category 4 or 5 filer does not have to file Form 5471 if the shareholder:

1. Does not own a direct or indirect interest in the foreign corporation and
2. Is required to file Form 5471 solely because of constructive ownership from a nonresident alien.

Additional Filing Requirements

Category 3 filers. Category 3 filers must attach a statement that includes:

1. The amount and type of any indebtedness the foreign corporation has with the related persons described in Regulations section 1.6046-1(b)(11) and
2. The name, address, identifying number, and number of shares subscribed to by each subscriber to the foreign corporation's stock.

Foreign sales corporations (FSCs).

- Category 2 and Category 3 filers who are shareholders, officers, and directors of a FSC (as defined in section 922, as in effect before its repeal) must file Form 5471 and separate Schedule O to report changes in the ownership of the FSC.
- Category 4 and 5 filers are not subject to the subpart F rules for:

1. Exempt foreign trade income,
2. Deductions that are apportioned or allocated to exempt foreign trade income,
3. Nonexempt foreign trade income (other than section 923(a)(2) nonexempt income, within the meaning of section 927(d)(6), as in effect before its repeal), and
4. Any deductions that are apportioned or allocated to the nonexempt foreign trade income described above.

- Category 4 and 5 filers are subject to the subpart F rules for:

1. All other types of FSC income (including section 923(a)(2) nonexempt income within the meaning of section 927(d)(6), as in effect before its repeal),
2. Investment income and carrying charges (as defined in sections 927(c) and 927(d)(1), as in effect before their repeal), and
3. All other FSC income that is not foreign trade income or investment income or carrying charges.

- Category 4 and 5 filers are not required to file a Form 5471 (in order to satisfy the requirements of section 6038) if the FSC has filed a Form 1120-FSC. See Temporary Regulations section 1.921-1T(b)(3). However, these filers may be required to file Form 5471 if they are subject to the subpart F rules with respect to certain types of FSC income (see above).

Section 338 election. If a section 338 election is made with respect to a qualified stock purchase of a foreign target corporation for which a Form 5471 must be filed:

- A purchaser (or its U.S. shareholder) must attach a copy of Form 8883, Asset Allocation Statement Under Section 338, to the first Form 5471 for the new foreign target corporation. See the Instructions for Form 8883 for details.
- A seller (or its U.S. shareholder) must attach a copy of Form 8883 to the last Form 5471 for the old foreign target corporation.

Penalties

Failure to file information required by section 6038(a) (Form 5471 and Schedule M).

- A $10,000 penalty is imposed for each annual accounting period of each foreign corporation for failure to furnish the required information within the time prescribed. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of $50,000 for each failure.
- Any person who fails to file or report all of the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit under sections 901, 902, and 960. If the failure continues 90 days or more after the date the IRS mails notice of the failure to the U.S. person, an additional 5% reduction is made for each 3-month period, or fraction thereof, during which the failure continues after the 90-day period has expired. See section 6038(c)(2) for limits on the amount of this penalty.

Failure to file information required by section 6046 and the related regulations (Form 5471 and Schedule O). Any person who fails to file or report all of the information requested by section 6046 is subject to a $10,000 penalty for each such failure for each reportable transaction. If the failure continues for more than 90 days after the date the IRS mails notice of the failure, an additional $10,000 penalty will apply for each 30-day period or fraction thereof during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of $50,000.

Criminal penalties. Criminal penalties under sections 7203, 7206, and 7207 may apply for failure to file the information required by sections 6038 and 6046.

Note. Any person required to file Form 5471 and Schedule J, M, or O who agrees to have another person file the form and schedules for him or her may be subject to the above penalties if the other person does not file a correct and proper form and schedule.

Other Reporting Requirements

Reporting Exchange Rates on Form 5471

When translating amounts from functional currency to U.S. dollars, you must use the method specified in these instructions. For example, when translating amounts to be reported on Schedule E, you generally must use the average exchange rate as defined in section 986(a). But, regardless of the specific method required, all exchange rates must be reported using a "divide-by convention" rounded to at least four places. That is, the exchange rate must be reported in terms of the amount by which the functional currency amount must be divided in order to reflect an equivalent amount of U.S. dollars. As such, the exchange rate must be reported as the units of foreign currency that equal one U.S. dollar, rounded to at least four places. **Do not** report the exchange rate as the number of U.S. dollars that equal one unit of foreign currency.

Note. You must round the result to more than four places if failure to do so would materially distort the exchange rate or the equivalent amount of U.S. dollars.

Example. During its annual accounting period, the foreign corporation paid income taxes of 30,255,400 Yen to Japan. The Schedule E instructions specify that the foreign corporation must translate these amounts into U.S. dollars at the average exchange rate for the tax year to which the tax relates in accordance with the rules of section 986(a). The average exchange rate is 118.5050 Japanese Yen to 1 U.S. dollar (0.00843846 U.S. dollars to 1 Japanese Yen). The foreign corporation divides 30,255,400 Yen by 118.5050 to determine the U.S. dollar amount to enter in column (d) of Schedule E. Line 2 of Schedule E is to be completed as follows: Enter "Japan" in column (a), "30,255,400" in column (b), "118.5050" in column (c), and "255,309" in column (d).

Computer-Generated Form 5471 and Schedules

A computer-generated Form 5471 and its schedules may be filed if they conform to and do not deviate from the official form and schedules. Generally, all computer-generated forms must receive

Instructions for Form 5471 -3-

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prior approval from the IRS and are subject to an annual review.

Requests for approval may be submitted electronically to *substituteforms@irs.gov*, or requests may be mailed to: Internal Revenue Service, Attention: Substitute Forms Program, SE:W:CAR:MP:T:T:SP, 1111 Constitution Avenue, NW, IR-6526, Washington, DC 20224.

Important: Be sure to attach the approval letter to Form 5471.

Every year, the IRS issues a revenue procedure to provide guidance for filers of computer-generated forms. In addition, every year the IRS issues Pub. 1167, General Rules and Specifications For Substitute Forms and Schedules, which reprints the most recent applicable revenue procedure. Pub. 1167 is available on the IRS website at *www.irs.gov*.

Dormant Foreign Corporations

Rev. Proc. 92-70, 1992-2 C.B. 435, provides a summary filing procedure for filing Form 5471 for a dormant foreign corporation (defined in sec. 3 of Rev. Proc. 92-70). This summary filing procedure will satisfy the reporting requirements of sections 6038 and 6046.

If you elect the summary procedure, complete only page 1 of Form 5471 for each dormant foreign corporation as follows:

- The top margin of the summary return must be labeled "Filed Pursuant to Rev. Proc. 92-70 for Dormant Foreign Corporation."
- Include filer information such as name and address, Items A through C, and tax year.
- Include corporate information such as the dormant corporation's annual accounting period (below the title of the form) and items 1a, 1b, 1c, and 1d.

For more information, see Rev. Proc. 92-70.

File this summary return in the manner described in *When and Where To File* on page 1.

Treaty-Based Return Positions

You are generally required to file Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), to disclose a return position that any treaty of the United States (such as an income tax treaty, an estate and gift tax treaty, or a friendship, commerce, and navigation treaty):

- Overrides or modifies any provision of the Internal Revenue Code and
- Causes, or potentially causes, a reduction of any tax incurred at any time.

See Form 8833 for exceptions.

Failure to make a required disclosure may result in a $1,000 penalty ($10,000 for a C corporation). See section 6712.

Section 362(e)(2)(C) Elections

The transferor and transferee in certain section 351 transactions may make a joint election under section 362(e)(2)(C) to limit the transferor's basis in the stock received instead of the transferee's basis in the transferred property. The election is made by a statement as provided in Notice 2005-70, 2005-41 I.R.B. 694, and regulations under section 362(e)(2).

Do not attach the statement described above to Form 5471.

Section 108(i) Elections

The controlling domestic shareholder(s) of a CFC may make the election under section 108(i) to defer recognizing discharge of indebtedness income in certain situations. The election is made by a statement as provided in Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

Do not attach the statement described above to Form 5471.

Corrections to Form 5471

If you file a Form 5471 that you later determine is incomplete or incorrect, file a corrected Form 5471 with an amended tax return, using the amended return instructions for the return with which you originally filed Form 5471. Write "corrected" at the top of the form and attach a statement identifying the changes.

Specific Instructions

Important: If the information required in a given section exceeds the space provided within that section, **do not** write "see attached" in the section and then attach all of the information on additional sheets. Instead, complete all entry spaces in the section and attach the remaining information on additional sheets. The additional sheets must conform with the IRS version of that section.

Identifying Information

Annual Accounting Period

Enter, in the space provided below the title of Form 5471, the annual accounting period of the foreign corporation for which you are furnishing information. Except for information contained on Schedule O, report information for the tax year of the foreign corporation that ends with or within your tax year. When filing Schedule O, report acquisitions, dispositions, and organizations or reorganizations that occurred during your tax year.

Specified foreign corporation. The annual accounting period of a specified foreign corporation is generally required to be the tax year of the corporation's majority U.S. shareholder. If there is more than one majority shareholder, the required tax year will be the tax year that results in the least aggregate deferral of income to all U.S. shareholders of the foreign corporation.

A specified foreign corporation is any foreign corporation:

1. That is treated as a CFC under subpart F and
2. In which more than 50% of the total voting power or value of all classes of stock of the corporation is treated as owned by a U.S. shareholder.

For more information, see section 898 and Rev. Procs. 2002-37, 2002-22 I.R.B. 1030, and 2002-39, 2002-22 I.R.B. 1046, as modified by Notice 2002-72, 2002-46 I.R.B. 843.

Name Change

If the name of either the person filing the return or the corporation whose activities are being reported changed within the past 3 years, show the prior name(s) in parentheses after the current name.

Address

Include the suite, room, or other unit number after the street address. If the post office does not deliver mail to the street address and the U.S. person has a P.O. box, show the box number instead.

Foreign address. Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code, if any. Do not abbreviate the country name.

Item A—Identifying Number

The identifying number of an individual is his or her social security number (SSN). The identifying number of all others is their employer identification number (EIN). If a U.S. corporation that owns stock in a foreign corporation is a member of a consolidated group, list the common parent as the person filing the return and enter its EIN in Item A. Identify the direct owner in Item D.

Item B—Category of Filer

Complete Item B to indicate the category or categories that describe the person filing this return. If more than one category applies, check all boxes that apply.

Item C—Percentage of Voting Stock Owned

Enter the total percentage of the foreign corporation's voting stock you owned directly, indirectly, or constructively at the end of the corporation's annual accounting period.

Item D—Person(s) on Whose Behalf This Information Return Is Filed

The person that files the required information on behalf of other persons must complete Item D. See *Multiple filers of same information* on page 2. In addition, a separate Schedule I must be filed for each person described in Category 4 or 5.

Except for members of the filer's consolidated return group, all persons identified in Item D must attach a statement to their tax returns that includes the following information:

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Continued on next page

• A statement that their filing requirements have been or will be satisfied;
• The name, address, and identifying number of the return with which the information was or will be filed; and
• The IRS Service Center where the return was or will be filed. If the return was or will be filed electronically, enter "e-file."

Items 1f and 1g—Principal Business Activity

Enter the principal business activity code number and the description of the activity from the list beginning on page 14.

Item 1h—Functional Currency

Enter the foreign corporation's functional currency. Regulations sections 1.6038-2(h) and 1.6046-1(g) require that certain amounts be reported in U.S. dollars and/or in the foreign corporation's functional currency. The specific instructions for the affected schedules state these requirements.

Special rules apply for foreign corporations that use the U.S. dollar approximate separate transactions method of accounting (DASTM) under Regulations section 1.985-3. See the instructions for Schedule C and Schedule H.

Schedule B

Category 3 and 4 filers must complete Schedule B for U.S. persons that owned (at any time during the annual accounting period), directly or indirectly through foreign entities, 10% or more in value or voting power of any class of the corporation's outstanding stock.

Column (e). Enter each shareholder's allocable percentage of the foreign corporation's subpart F income.

Schedule C

If the foreign corporation uses the U.S. dollar approximate separate transactions method of accounting (DASTM) under Regulations section 1.985-3, the functional currency column should reflect local hyperinflationary currency amounts computed in accordance with U.S. Generally Accepted Accounting Principles (GAAP). The U.S. dollar column should reflect such amounts translated into dollars under U.S. GAAP translation rules. Differences between this U.S. dollar GAAP column and the U.S. dollar income or loss figured for tax purposes under Regulations section 1.985-3(c) should be accounted for on Schedule H. See *Schedule H, Special rules for DASTM,* below.

Line 19. The terms "extraordinary items" and "prior period adjustments" have the same meaning given to them by U.S. GAAP (see Opinion No. 30 of the Accounting Principles Board and Statement No. 16 of the Financial Accounting Standards Board).

Line 20. Enter the income, war profits, and excess profits taxes deducted in accordance with U.S. GAAP.

Important: Differences between this functional currency amount and the amount of taxes that reduce U.S. E&P should be accounted for on line 2g of Schedule H.

Schedule E

List income, war profits, and excess profits taxes paid or accrued to the United States and to any foreign country or U.S. possession for the annual accounting period. Report these amounts in column (b) in the local currency in which the taxes are payable. Translate these amounts into U.S. dollars at the average exchange rate for the tax year to which the tax relates unless one of the exceptions below applies. See section 986(a).

Exceptions. If one of the following exceptions applies, use the exchange rate in effect on the date you paid the tax.

1. The tax is paid before the beginning of the year to which the tax relates.
2. For tax years beginning after December 31, 2004, there is an election in effect under section 986(a)(1)(D) to translate foreign taxes attributable to the CFC using the exchange rate in effect on the date of payment.

Enter the exchange rate used in column (c). Report the exchange rate using the "divide-by convention" specified under *Reporting Exchange Rates on Form 5471* on page 3. Enter the translated dollar amount in column (d).

Schedule F

If the foreign corporation uses DASTM, the tax balance sheet on Schedule F should be prepared and translated into U.S. dollars according to Regulations section 1.985-3(d), rather than U.S. GAAP.

Schedule G

Question 1

If the foreign corporation owned at least a 10% interest, directly or indirectly, in any foreign partnership, attach a statement listing the following information for each foreign partnership:

1. Name and EIN (if any) of the foreign partnership;
2. Identify which, if any, of the following forms the foreign partnership filed for its tax year ending with or within the corporation's tax year: Form 1042, 1065 or 1065-B, or 8804;
3. Name of the tax matters partner (if any); and
4. Beginning and ending dates of the foreign partnership's tax year.

Question 3

Check the "Yes" box if the foreign corporation is the tax owner of a foreign disregarded entity (FDE). The "tax owner" of an FDE is the person that is treated as owning the assets and liabilities of the FDE for purposes of U.S. income tax law.

If the foreign corporation is the tax owner of an FDE and you are a category 4 or 5 filer of Form 5471, you are required to attach Form 8858 to Form 5471.

If the foreign corporation is the tax owner of an FDE and you are not a category 4 or 5 filer of Form 5471, you must attach the statement described below in lieu of Form 8858.

Statement in lieu of Form 8858. This statement must list the name of the FDE, country under whose laws the FDE was organized, and EIN (if any) of the FDE.

Schedule H

Use Schedule H to report the foreign corporation's current earnings and profits (E&P) for U.S. tax purposes. Enter the amounts on lines 1 through 5c in functional currency.

Special rules for DASTM. If the foreign corporation uses DASTM, enter on line 1 the dollar GAAP income or (loss) from line 21 of Schedule C. Enter on lines 2a through 4 the adjustments made in figuring current E&P for U.S. tax purposes. Report these amounts in U.S. dollars. Enter on line 5b the DASTM gain or loss figured under Regulations section 1.985-3(d).

Lines 2a through 2h. Certain adjustments (required by Regulations sections 1.964-1(b) and (c)) must be made to the foreign corporation's line 1 net book income or (loss) to determine its current E&P. These adjustments may include both positive and negative adjustments to conform the foreign book income to U.S. GAAP and to U.S. tax accounting principles. If the foreign corporation's books are maintained in functional currency in accordance with U.S. GAAP, enter on line 1 the functional currency GAAP income or (loss) from line 21 of Schedule C, rather than starting with foreign book income, and show GAAP-to-tax adjustments on lines 2a through 2h.

Lines 2b and 2c. Generally, depreciation, depletion, and amortization allowances must be based on the historical cost of the underlying asset, and depreciation must be figured according to section 167. However, if 20% or more of the foreign corporation's gross income is from U.S. sources, depreciation must be figured on a straight line basis according to Regulations section 1.312-15.

Line 2f. Inventories must be taken into account according to the rules of sections 471 (incorporating the provisions of section 263A) and 472 and the related regulations.

Line 2g. See the instructions for Schedule C, line 20 above.

Line 2h. Enter the net amount of any additional adjustments not included on lines 2a through 2g. List these additional adjustments on a separate schedule. Attach this schedule to Form 5471.

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Line 5b. DASTM gain or (loss), reflecting unrealized exchange gain or loss, should be entered on line 5b only for foreign corporations that use DASTM.

Line 5d. Enter the line 5c functional currency amount translated into U.S. dollars at the average exchange rate for the foreign corporation's tax year. See section 989(b). Report the exchange rate using the "divide-by convention" specified under *Reporting Exchange Rates on Form 5471* on page 3. If the foreign corporation uses DASTM, enter on line 5d the same amount entered on line 5c.

Blocked income. The E&P of the foreign corporation, as reflected on Schedule H, must not be reduced by all or any part of such E&P that could not have been distributed by the foreign corporation due to currency or other restrictions or limitations imposed under the laws of any foreign country.

Schedule I

Use Schedule I to report in U.S. dollars the U.S. shareholder's pro rata share of income from the foreign corporation reportable under subpart F and other income realized from a corporate distribution.

Line 1

Subpart F income. Generally, the income of a foreign corporation with U.S. shareholders is not taxed to those U.S. shareholders until the income is repatriated to the United States (e.g., through the payment of dividends to the U.S. shareholders or in the form of gain on the disposition of the U.S. shareholders' stock in the foreign corporation). However, this deferral of U.S. tax is not available to U.S. shareholders of CFCs with certain types of income, including subpart F income. For more information, see sections 951 and 952.

Use Worksheet A (which begins on page 8) to compute the U.S. shareholder's pro rata share of subpart F income of the CFC. Subpart F income includes the following:

- Adjusted net foreign base company income (lines 1 through 19);
- Adjusted net insurance income (line 20);
- Adjusted net related person insurance income (line 21);
- International boycott income (line 22);
- Illegal bribes, kickbacks, and other payments (line 23); and
- Income from a country described in section 952(a)(5) (line 24).

Important: If the subpart F income of any CFC for any tax year was reduced because of the current E&P limitation (see the instructions for line 29 of Worksheet A on page 10), any excess of the E&P of the CFC for any subsequent tax year over the subpart F income of the CFC for the tax year must be recharacterized as subpart F income.

Lines 2 Through 4

Other amounts not eligible for deferral that are reported on Schedule I include:

- Earnings invested in U.S. property (Worksheet B);
- Amounts withdrawn from qualified investments in less developed countries and amounts withdrawn from qualified investments in foreign base company shipping operations (Worksheet C); and
- Amounts withdrawn from investment in export trade assets (Worksheet D).

Line 5

Enter the factoring income (as defined in section 864(d)(1)) if no subpart F income is reported on line 1a, Worksheet A, because of the operation of the de minimis rule (see lines 1a, 9, and 11 of Worksheet A and the related instructions).

Line 6

Add lines 1 through 5. Enter the result here and on your tax return. For a corporate U.S. shareholder, enter the result on Form 1120, Schedule C, line 14, or on the comparable line of other corporate tax returns. For a noncorporate U.S. shareholder, enter the result on Form 1040, line 21 (Other income), or on the comparable line of other noncorporate tax returns.

Line 7

Enter the dividends you received from the foreign corporation that were not previously taxed under subpart F in the current year or in any prior year.

Line 8

If previously taxed E&P described in section 959(a) or (b) was distributed, enter the amount of foreign currency gain or (loss) on the distribution, computed under section 986(c). See Notice 88-71, 1988-2 C.B. 374, for rules for computing section 986(c) gain or (loss).

For a corporate U.S. shareholder, include the gain or (loss) as "other income" on line 10 of Form 1120, or on the comparable line of other corporate tax returns. For a noncorporate U.S. shareholder, include the result as "other income" on line 21 of Form 1040, or on the comparable line of other noncorporate tax returns.

Worksheet A

Important: For tax years beginning after December 31, 2004, foreign base company income does not include foreign base company shipping income as defined in former section 954(f).

For tax years beginning after December 31, 1998, and before January 1, 2010, the following exceptions apply:

- Foreign personal holding company income generally shall not include income derived in the active conduct of a CFC of a banking, finance, or similar business (section 954(h)).
- Foreign personal holding company and insurance income shall not include certain investment income derived by a qualifying insurance company and by certain qualifying insurance branches (sections 953(a)(2) and 954(i)).
- Foreign base company services income shall not include income that is exempt insurance income under section 953(e) or that is not treated as foreign personal holding company income under the active conduct of an insurance business exception (section 954(i)); the active conduct of a banking, financing, or similar business exception (section 954(h)); or the securities dealer exception (section 954(c)(2)(C)(ii)).

Line 1a. Do not include the following:

- Interest from conducting a banking business that is "export financing interest" (section 904(d)(2)(G));
- Rents and royalties from actively conducting a trade or business received from a person other than a "related person" (as defined in section 954(d)(3)); and
- Dividends, interest, rent or royalty income from related corporate payors described in section 954(c)(3). However, see section 964(e) for an exception.

Interest income includes factoring income arising when a person acquires a trade or service receivable (directly or indirectly) from a related person. The income is treated as interest on a loan to the obligor under section 864(d)(1) and is generally not eligible for the de minimis, export financing, and related party exceptions to the inclusion of subpart F income. Also, a trade or service receivable acquired or treated as acquired by a CFC from a related U.S. person is considered an investment in U.S. property for purposes of section 956 (Worksheet B) if the obligor is a U.S. person.

Line 1b. Enter the excess of gains over losses from the sale or exchange of:

- Property that produces the type of income reportable on line 1a. For tax years beginning after December 31, 1998, and before January 1, 2010, see section 954(c)(1)(B)(i).
- An interest in a trust, partnership, or REMIC. However, see the instructions for line 1i for an exception that provides for look-through treatment for certain sales of partnership interests.
- Property that does not produce any income.

Do not include:

- Income, gain, deduction, or loss from any transaction (including a hedging transaction) and transactions involving physical settlement of a regular dealer in property, forward contracts, option contracts, and similar financial instruments (section 954(c)(2)(C)).
- Gains and losses from the sale or exchange of any property that, in the hands of the CFC, is property described in section 1221(a)(1).

Line 1c. Enter the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities. See section

Continued on next page

954(c)(1)(C) for exceptions. See section 954(c)(5) for a definition and special rules relating to commodity transactions.

Line 1d. Enter the excess of foreign currency gains over foreign currency losses from section 988 transactions. An exception applies to transactions directly related to the business needs of a CFC.

Line 1e. Enter any income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made.

Line 1f. Include net income from notional principal contracts (except a contract entered into to hedge inventory property).

Line 1g. Include payments in lieu of dividends that are made as required under section 1058.

Line 1h. Enter amounts received:

- Under a contract under which the corporation is to furnish personal services if (a) some person other than the corporation has a right to designate (by name or by description) the individual who is to perform the services or (b) the individual who is to perform the services is designated (by name or by description) in the contract, and
- From the sale or other disposition of such a contract.

Note. The above rules apply with respect to amounts received for services under a particular contract only if at some time during the tax year 25% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

Line 1i. For tax years beginning after December 31, 2004, in the case of any sale by a CFC of an interest in a partnership with respect to which the CFC is a 25% owner (defined below), such CFC is treated for purposes of computing its foreign personal holding company income as selling the proportionate share of the assets of the partnership attributable to such interest. Thus, the sale of a partnership interest by a CFC that meets the ownership threshold constitutes subpart F income only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income. Do not report these amounts on line 1b. Instead, report them on new line 1i.

25% owner. For purposes of these rules, a 25% shareholder is a CFC that owns directly 25% or more of the capital or profits interest in a partnership. For purposes of the preceding sentence, if a CFC is a shareholder or partner of a corporation or partnership, the CFC is treated as owning directly its proportionate share of any such capital or profits interest held directly or indirectly by such corporation or partnership. If a CFC is treated as owning a capital or profits interest in a partnership under constructive ownership rules similar to the rules of section 958(b), the CFC shall be treated as owning such interest directly or indirectly for purposes of this definition.

Line 11. De minimis rule. If the sum of foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income (as defined in section 954(b)(3)(C)) for the tax year is **less than** the smaller of 5% of gross income for income tax purposes, or $1 million, then no portion of the gross income for the tax year is treated as foreign base company income or insurance income. In this case, enter zero on line 11 and skip lines 12 through 21. Otherwise, go to line 12.

Line 12. Full inclusion rule. If the sum of foreign base company income (determined without regard to section 954(b)(5)) and gross insurance income for the tax year exceeds 70% of gross income for income tax purposes, the entire gross income for the tax year must (subject to the high tax exception described below, the section 952(b) exclusion, and the deductions to be taken into account under section 954(b)(5)) be treated as foreign base company income or insurance income, whichever is appropriate. In this case, enter total gross income (for income tax purposes) on line 12. Otherwise, enter zero.

Lines 14g, 15d, 16d, 18d, 20d, and 21d. Exception for certain income subject to high foreign taxes. Foreign base company income and insurance income does not include any item of income received by a CFC if the taxpayer establishes that such income was subject to an effective rate of income tax imposed by a foreign country that is greater than 90% of the maximum rate of tax specified in section 11. This rule does not apply to foreign base company oil-related income. For more information, see section 954(b)(4) and Regulations section 1.954-1(d)(1).

Line 20. Adjusted net insurance income. In determining a shareholder's pro rata share of the subpart F income of a CFC, insurance income is any income:

- That is attributable to the issuing (or reinsuring) of any insurance or annuity contract:

  1. For property in, liability from an activity in, or for the lives or health of residents of a country other than the country under the laws of which the CFC is created or organized or
  2. For risks not described in 1 above, resulting from any arrangement in which another corporation receives a substantially equal amount of premiums or other consideration for issuing (or reinsuring) a contract described in 1 above.

- That would, subject to the modifications provided in sections 953(b)(1) and 953(b)(2), be taxed under subchapter L (insurance company tax) if such income were income of a domestic insurance company.

Line 21. Adjusted net related person insurance income. In determining a shareholder's pro rata share of the subpart F income of a CFC, related person insurance income is any insurance income (within the meaning of section 953(a)) attributable to a policy of insurance or reinsurance for which the person insured (directly or indirectly) is a U.S. shareholder (as defined in section 953(c)(1)(A)) in a CFC, or a related person (as defined in section 953(c)(6)) to such a shareholder. In such case, the pro rata share referred to above is to be determined under the rules of section 953(c)(5).

Exceptions. The above definition does not apply to any foreign corporation if:

- At all times during the foreign corporation's tax year, less than 20% of the total combined voting power of all classes of stock of the corporation entitled to vote, and less than 20% of the total value of the corporation, is owned (directly or indirectly under the principles of section 883(c)(4)) by persons who are (directly or indirectly) insured under any policy of insurance or reinsurance issued by the corporation or who are related persons to any such person;
- The related person insurance income (determined on a gross basis) of the corporation for the tax year is less than 20% of its insurance income for the tax year determined without regard to the provisions of section 953(a)(1) that limit insurance income to income from countries other than the country in which the corporation was created or organized; or
- The corporation:

  1. Elects to treat its related person insurance income for the tax year as income effectively connected with the conduct of a trade or business in the United States;
  2. Elects to waive all treaty benefits (other than from section 884) for related person insurance income; and
  3. Meets any requirement the IRS may prescribe to ensure that any tax on such income is paid.

This election will not be effective if the corporation was a disqualified corporation (as defined in section 953(c)(3)(E)) for the tax year for which the election was made or for any prior tax year beginning after 1986. See section 953(c)(3)(D) for special rules for this election.

Mutual life insurance companies. The related person insurance income rules also apply to mutual life insurance companies under regulations prescribed by the Secretary. For these purposes, policyholders must be treated as shareholders.

Line 22. International boycott income. If a CFC or a member of a controlled group (within the meaning of section 993(a)(3)) that includes the CFC has operations in, or related to, a country (or with the government, a company, or a national of a country) that requires participation in or cooperation with an

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Worksheet A—Foreign Base Company Income and Insurance Income and Summary of U.S. Shareholder's Pro Rata Share of Subpart F Income of a CFC (See instructions beginning on page 6.)
Enter the amounts on lines 1a through 38a in functional currency.

1	**Gross foreign personal holding company income:**		
a	Dividends, interest, royalties, rents, and annuities (section 954(c)(1)(A)) (excluding amounts described in sections 954(c)(2), (3), and (6))	1a	
b	Excess of gains over losses from certain property transactions (section 954(c)(1)(B))	1b	
c	Excess of gains over losses from commodity transactions (section 954(c)(1)(C))	1c	
d	Excess of foreign currency gains over foreign currency losses (section 954(c)(1)(D))	1d	
e	Income equivalent to interest (section 954(c)(1)(E))	1e	
f	Net income from a notional principal contract (section 954(c)(1)(F))	1f	
g	Payments in lieu of dividends (section 954(c)(1)(G))	1g	
h	Certain amounts received for services under personal service contracts (see section 954(c)(1)(H))	1h	
i	Certain amounts from sales of partnership interests to which the look-through rule of section 954(c)(4) applies	1i	
2	Gross foreign personal holding company income. Add lines 1a through 1i		2
3	Gross foreign base company sales income (see section 954(d))		3
4	Gross foreign base company services income (see section 954(e))		4
5	Gross foreign base company oil-related income (see section 954(g)) after application of section 954(b)(6)		5
6	Gross foreign base company income. Add lines 2 through 5		6
7	Gross insurance income (see sections 953 and 954(b)(3)(C) and the instructions for lines 20 and 21)		7
8	Gross foreign base company income and gross insurance income. Add lines 6 and 7		8
9	Enter 5% of total gross income (as computed for income tax purposes)		9
10	Enter 70% of total gross income (as computed for income tax purposes)		10
11	If line 8 is less than line 9 and less than $1 million, enter -0- on this line and skip lines 12 through 21		11
12	If line 8 is more than line 10, enter total gross income (as computed for income tax purposes)		12
13	**Total adjusted gross foreign base company income and insurance income** (enter the greater of line 8 or line 12)		13
14	**Adjusted net foreign personal holding company income:**		
a	Enter amount from line 2	14a	
b	Expenses directly related to amount on line 2	14b	
c	Subtract line 14b from line 14a	14c	
d	Related person interest expense (see section 954(b)(5))	14d	
e	Other expenses allocated and apportioned to the amount on line 2 under section 954(b)(5)	14e	
f	Net foreign personal holding company income. Subtract the sum of lines 14d and 14e from line 14c	14f	
g	Net foreign personal holding company income excluded under high-tax exception	14g	
h	Subtract line 14g from line 14f		14h
15	**Adjusted net foreign base company sales income:**		
a	Enter amount from line 3	15a	
b	Expenses allocated and apportioned to the amount on line 3 under section 954(b)(5)	15b	
c	Net foreign base company sales income. Subtract line 15b from line 15a	15c	
d	Net foreign base company sales income excluded under high-tax exception	15d	
e	Subtract line 15d from line 15c		15e
16	**Adjusted net foreign base company services income:**		
a	Enter amount from line 4	16a	
b	Expenses allocated and apportioned to line 4 under section 954(b)(5)	16b	
c	Net foreign base company services income. Subtract line 16b from line 16a	16c	
d	Net foreign base company services income excluded under high-tax exception	16d	
e	Subtract line 16d from line 16c		16e

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Worksheet A (continued) (See instructions.)

17	**Adjusted net foreign base company oil-related income:**		
a	Enter amount from line 5	17a	
b	Expenses allocated and apportioned to line 5 under section 954(b)(5)	17b	
c	Subtract line 17b from line 17a		17c
18	**Adjusted net full inclusion foreign base company income:**		
a	Enter the excess, if any, of line 12 over line 8	18a	
b	Expenses allocated and apportioned under section 954(b)(5)	18b	
c	Net full inclusion foreign base company income. Subtract line 18b from line 18a	18c	
d	Net full inclusion foreign base company income excluded under high-tax exception	18d	
e	Subtract line 18d from line 18c		18e
19	**Adjusted net foreign base company income.** Add lines 14h, 15e, 16e, 17c, and 18e		19
20	**Adjusted net insurance income** (other than related person insurance income):		
a	Enter amount from line 7 (other than related person insurance income)	20a	
b	Expenses allocated and apportioned to the amount from line 7 under section 953	20b	
c	Net insurance income. Subtract line 20b from line 20a	20c	
d	Net insurance income excluded under high-tax exception	20d	
e	Subtract line 20d from line 20c		20e
21	**Adjusted net related person insurance income:**		
a	Enter amount from line 7 that is related person insurance income	21a	
b	Expenses allocated and apportioned to related person insurance income under section 953	21b	
c	Net related person insurance income. Subtract line 21b from line 21a	21c	
d	Net related person insurance income excluded under high-tax exception	21d	
e	Subtract line 21d from line 21c		21e
22	International boycott income (section 952(a)(3))		22
23	Illegal bribes, kickbacks, and other payments (section 952(a)(4))		23
24	Income described in section 952(a)(5) (see instructions)		24
25	Subpart F income before application of sections 952(b) and (c) and section 959(b). Add lines 19, 20e, 21e, and 22 through 24		25
26	Enter portion of line 25 that is U.S. source income effectively connected with a U.S. trade or business (section 952(b))	26	
27	Exclusions under section 959(b)	27	
28	Total subpart F income. Subtract the sum of lines 26 and 27 from line 25		28
29	Current E&P		29
30	Enter the smaller of line 28 or line 29		30
31	Shareholder's pro rata share of line 30	31	
32	Shareholder's pro rata share of export trade income	32	
33	Subtract line 32 from line 31	33	
34	Divide the number of days in the tax year that the corporation was a CFC by the number of days in the tax year and multiply the result by line 33	34	
35	Dividends paid to any other person with respect to your stock during the tax year	35	
36	Divide the number of days in the tax year you did not own such stock by the number of days in the tax year and multiply the result by line 33	36	
37	Enter the smaller of line 35 or line 36	37	
38a	**Shareholder's pro rata share of subpart F income.** Subtract line 37 from line 34		38a
b	Translate the amount on line 38a from functional currency to U.S. dollars at the average exchange rate. See section 989(b). Enter the result here and on line 1, Schedule I		38b

Continued on next page

international boycott as a condition of doing business within such country or with the government, company, or national of that country, a portion of the CFC's income is included in subpart F income. The amount included is determined by multiplying the CFC's income (other than income included under section 951 and U.S. source effectively connected business income described in section 952(b)) by the international boycott factor. This factor is a fraction determined on Schedule A (Form 5713).

Special rule. If the shareholder of a CFC can clearly demonstrate that the income earned for the tax year is from specific operations, then, instead of applying the international boycott factor, the addition to subpart F income is the amount specifically from the operations in which there was participation in or cooperation with an international boycott. See Schedule B (Form 5713).

Line 23. Illegal bribes, kickbacks, and other payments. Enter the total of any illegal bribes, kickbacks, or other payments (within the meaning of section 162(c)) paid by or on behalf of the corporation, directly or indirectly, to an official, employee, or agent of a government.

Line 24. Income described in section 952(a)(5). The income of a CFC derived from any foreign country during any period during which section 901(j) applies to such foreign country will be deemed to be income to the U.S. shareholders of such CFC. As of the date these instructions were revised, section 901(j) applied to: Cuba, Iran, North Korea, Sudan, and Syria.

Line 26. Exclusion of U.S. income. Subpart F income does not include any U.S. source income (which, for these purposes, includes all carrying charges and all interest, dividends, royalties, and other investment income received or accrued by a FSC) that is effectively connected with a CFC's conduct of a trade or business in the United States unless that item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States or the Code.

Line 29. Current E&P. A CFC's subpart F income is limited to its current year E&P, computed under the special rule of section 952(c)(3). The amount included in the gross income of a U.S. shareholder of a CFC under section 951(a)(1)(A)(i) for any tax year and attributable to a qualified activity must be reduced by the shareholder's pro rata share of any qualified deficit (see section 952(c)(1)(B)).

Certain current year deficits of a member of the same chain of corporations may be considered in determining subpart F income. See section 952(c)(1)(C).

Worksheet B

Use Worksheet B (on page 11) to determine a U.S. shareholder's pro rata share of earnings of a CFC invested in U.S. property that is subject to tax. Only earnings of a CFC not distributed or otherwise previously taxed are subject to these rules. Thus, the amount of previously **untaxed** earnings limits the section 956 inclusion. A CFC's investment in U.S. property in excess of this limit will not be included in the taxable income of the CFC's U.S. shareholders.

Further, U.S. shareholders are only taxed on earnings invested in U.S. property to the extent the investments exceed the CFC's previously **taxed** earnings. The balances in the previously taxed accounts of prior section 956 inclusions (see section 959(c)(1)(A)) and current or prior subpart F inclusions (see section 959(c)(2)) reduce what would otherwise be the current section 956 inclusion.

Note. The previously taxed accounts should be adjusted to reflect any reclassification of subpart F inclusions that reduced prior section 956 or 956A inclusions (see section 959(a)(2) and Schedule J).

Distributions are also taken into account before the section 956 inclusion is determined. Distributions generally are treated as coming first from (and thus reducing the balances of) the previously taxed accounts. Thus, the U.S. shareholders must:

1. Compute the current subpart F inclusion (potentially increasing that previously taxed account);
2. Take into account current distributions (potentially reducing the previously taxed and untaxed accounts); and
3. Compute the current section 956 inclusion (potentially increasing or reclassifying the previously taxed accounts).

U.S. property is measured on a quarterly average basis. For purposes of Worksheet B, the amount taken into account with respect to U.S. property is its adjusted basis for earnings and profits purposes, reduced by any liability the property is subject to. See sections 956(c) and (d) for the definition of U.S. property. The amount of U.S. property held (directly or indirectly) by the CFC does not include any item that was acquired by the foreign corporation before it became a CFC, except for the property acquired before the foreign corporation became a CFC that exceeds the applicable earnings (as defined in section 956(b)) accumulated during periods before it became a CFC.

If the foreign corporation **ceases to be a CFC** during the tax year:

- The determination of the U.S. shareholder's pro rata share will be made based upon the stock owned (within the meaning of section 958(a)) by the U.S. shareholder on the last day during the tax year in which the foreign corporation was a CFC;
- The CFC's U.S. property for the taxable year will be determined only by taking into account quarters ending on or before such last day (and investments in U.S. property as of the close of subsequent quarters should be recorded as zero on line 1); and
- In determining applicable earnings, current earnings and profits will include only earnings and profits that are allocable (on a pro rata basis) to the part of the year during which the foreign corporation was a CFC.

Schedule J

Use Schedule J to report accumulated E&P, in functional currency, computed under sections 964(a) and 986(b).

Column (a)

Use column (a) to report the opening balance, current year additions and subtractions, and the closing balance in the foreign corporation's post-1986 undistributed earnings pool.

Note. Line 3 (E&P as of the close of the tax year, before actual or deemed distributions during the year) is the denominator of the deemed-paid credit fraction under section 902(c)(1) used for foreign tax credit purposes.

Column (b)

Use column (b) to report the aggregate amount of the foreign corporation's pre-1987 section 964(a) E&P accumulated since 1962 and not previously distributed or deemed distributed. These amounts are figured in U.S. dollars using the rules of Regulations sections 1.964-1(a) through (e), translated into the foreign corporation's functional currency according to Notice 88-70, 1988-2 C.B. 369.

Column (c)

Use column (c) to report the running balance of the foreign corporation's previously taxed earnings and profits (PTI), or section 964(a) E&P accumulated since 1962 that have resulted in deemed inclusions under subpart F. Pre-1987 U.S. dollar PTI should be translated into the foreign corporation's functional currency using the rules of Notice 88-70 and added to post-1986 amounts in the appropriate PTI category.

- Include in column (c)(i) PTI attributable to, or reclassified as, investments in U.S. property (section 959(c)(1)(A) amounts).
- Include in column (c)(ii) PTI attributable to, or reclassified as, earnings invested in excess passive assets (section 959(c)(1)(B) amounts) accumulated in tax years of foreign corporations beginning after September 30, 1993, and before January 1, 1997.
- Include in column (c)(iii) PTI attributable to subpart F income net of any reclassifications (section 959(c)(2) amounts).

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Worksheet B—U.S. Shareholder's Pro Rata Share of Earnings of a CFC Invested in U.S. Property
Enter the amounts on lines 1 through 16 in functional currency.

1	Amount of U.S. property (as defined in sections 956(c) and (d)) held (directly or indirectly) by the CFC as of the close of:				
a	The first quarter of the tax year	1a			
b	The second quarter of the tax year	1b			
c	The third quarter of the tax year	1c			
d	The fourth quarter of the tax year	1d			
2	Number of quarter-ends the foreign corporation was a CFC during the tax year ▶			2	
3	Average amount of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of the tax year. (Add lines 1a through 1d. Divide this amount by the number on line 2.)			3	
4	U.S. shareholder's pro rata share of the amount on line 3			4	
5	U.S. shareholder's earnings and profits described in section 959(c)(1)(A) after reductions (if any) for current year distributions			5	
6	Subtract line 5 from line 4			6	
7	Applicable earnings:				
a	Current earnings and profits	7a			
b	Line 7a plus accumulated earnings and profits	7b			
8	Enter the greater of line 7a or line 7b			8	
9	Distributions made by the CFC during the tax year			9	
10	Subtract line 9 from line 8			10	
11	Earnings and profits described in section 959(c)(1)			11	
12	Subtract line 11 from line 10			12	
13	U.S. shareholder's pro rata share of the amount on line 12			13	
14	U.S. shareholder's earnings invested in U.S. property. (Enter the smaller of line 6 or line 13)			14	
15	Amount on line 14 that is excluded from the U.S. shareholder's gross income under section 959(a)(2)			15	
16	Subtract line 15 from line 14			16	
17	Translate the amount on line 16 from functional currency to U.S. dollars at the year-end spot rate (as provided in section 989(b)). Enter the result here and on line 2 of Schedule I			17	

Column (d)

Use column (d) to report the opening and closing balance of the foreign corporation's accumulated E&P. This amount is the sum of post-1986 undistributed earnings, pre-1987 section 964(a) E&P not previously taxed, and PTI.

Schedule M

Important: In translating the amounts from functional currency to U.S. dollars, use the average exchange rate for the foreign corporation's tax year. See section 989(b). Report the exchange rate in the entry space provided at the top of Schedule M using the "divide-by convention" specified under *Reporting Exchange Rates on Form 5471* on page 3.

Every U.S. person described in Category 4 must file Schedule M to report the transactions that occurred during the foreign corporation's annual accounting period ending with or within the U.S. person's tax year.

If a U.S. corporation that owns stock in a foreign corporation is a member of a consolidated group, list the common parent as the U.S. person filing Schedule M.

Lines 4 and 16. Report on these lines cost sharing buy-in payments received and paid by the foreign corporation (without giving effect to any netting of payments due and owed). See Regulations section 1.482-7(g). The corporation is required to complete **both** lines only if the corporation makes pre-existing intangible property available to other controlled cost sharing arrangement participants **and** is required to make buy-in payments to other controlled participants that make pre-existing intangible property available to other controlled cost sharing arrangement participants.

Lines 5 and 17. Report on these lines cost sharing payments received and paid by the foreign corporation (without giving effect to any netting of payments due and owed). See Regulations section 1.482-7(d)(1). The corporation is required to complete line 5 only if the corporation itself incurred costs related to the intangible development area (e.g. research and development). If the corporation does not itself incur costs related to the intangible development area, then it should **only** report cost sharing payments made on line 17.

Lines 9 and 21. Report on these lines dividends received and paid by the foreign corporation not previously taxed under subpart F in the current year or in any prior year.

Lines 25 and 26. Report on these lines the largest outstanding balances during the year of gross amounts borrowed from, and gross amounts loaned to, the related parties described in columns (b) through (f). Do not enter aggregate cash flows, year-end loan balances, average balances, or net balances. Do not include open account balances resulting from sales and purchases reported under other items listed on Schedule M that arise and are collected in full in the ordinary course of business.

Accrued payments and receipts. A corporation that uses an accrual method of accounting must use accrued payments and accrued receipts for purposes of computing the total amount to enter on each line of Schedule M.

Schedule O

Schedule O is used to report the organization or reorganization of a foreign corporation and the acquisition or disposition of its stock.

Every U.S. citizen or resident described in Category 2 must complete Part I. Every U.S. person described in Category 3 must complete Part II.

See Regulations section 1.6046-1(i) for rules on determining when U.S. persons constructively own stock of a foreign corporation and therefore are subject to the section 6046 filing requirements.

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Enter the amounts on lines 1 through 6a in functional currency.

1	Decrease in qualified investments in less developed countries (see Regulations section 1.955-1(b)(1)) and foreign base company shipping operations (see Regulations section 1.955A-1(b)(1)).	1	
a	Enter the sum of E&P for the tax year and E&P accumulated for prior tax years beginning after 1962	2a	
b	Enter the sum of amounts invested in less developed countries or foreign base company shipping operations and excluded from foreign base company income for all prior tax years, minus the sum of such amounts withdrawn for such years (see Regulations section 1.955-1(b)(2)(i)).	2b	
3	Enter the smaller of line 2a or line 2b	3	
4	Previously excluded subpart F income withdrawn for the tax year (enter the smaller of line 1 or line 3).	4	
5	U.S. shareholder's pro rata share of line 4 (see Regulations section 1.955-1(c))	5	
6a	Divide the number of days in the tax year that the foreign corporation was a CFC by the number of days in the tax year and multiply the result by line 5	6a	
b	Translate the amount on line 6a from functional currency to U.S. dollars at the average exchange rate. See section 989(b). Enter the result here and on line 3, Schedule I	6b	

Worksheet D—U.S. Shareholder's Pro Rata Share of Previously Excluded Export Trade Income of a CFC Withdrawn From Investment in Export Trade Assets

Enter the amounts on lines 1 through 7a in functional currency.

1	Decrease in investments of the CFC in export trade assets (see Regulations section 1.970-1(d)(3))	1	
2	U.S. shareholder's pro rata share of line 1	2	
3	U.S. shareholder's pro rata share of the sum of E&P of the CFC for the tax year and E&P accumulated for prior tax years beginning after 1962 (see Regulations section 1.970-1(c)(2)(i))	3	
4	Limitation under section 970(b) (see Regulations section 1.970-1(c)(2)(i)):		
a	U.S. shareholder's pro rata share of the sum of the amounts by which the CFC's subpart F income for prior tax years was reduced under section 970(a)	4a	
b	U.S. shareholder's pro rata share of the sum of the amounts that were not included in subpart F income of the CFC for prior tax years because of Regulations section 1.972-1	4b	
c	Add lines 4a and 4b.	4c	
d	U.S. shareholder's pro rata share of the sum of the amounts that were previously included in his or her gross income for prior tax years under section 951(a)(1)(A)(ii) because of section 970(b)	4d	
5	Subtract line 4d from line 4c	5	
6	Enter the smallest of line 2, 3, or 5	6	
7a	Divide the number of days in the tax year that the foreign corporation was a CFC by the number of days in the tax year and multiply the result by line 6	7a	
b	Translate the amount on line 7a from functional currency to U.S. dollars at the average exchange rate. See section 989(b). Enter the result here and on line 4, Schedule I	7b	

Part I

Column (d). Enter the date the shareholder first acquired 10% or more (in value or voting power) of the outstanding stock of the foreign corporation.

Column (e). Enter the date the shareholder acquired (whether in one or more transactions) an additional 10% or more (in value or voting power) of the outstanding stock of the foreign corporation.

Part II

Section A—General Shareholder Information

If the shareholder's latest tax return was filed electronically, enter "e-filed" in column (b)(3) instead of a service center.

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Section C—Acquisition of Stock

Section C is completed by shareholders who are completing Schedule O because they have acquired sufficient stock in a foreign corporation. If the shareholder acquired the stock in more than one transaction, use a separate line to report each transaction.

Column (d). Enter the method of acquisition (e.g., purchase, gift, bequest, trade).

Column (e)(2). Enter the number of shares acquired indirectly (within the meaning of section 958(a)(2)) by the shareholder listed in column (a).

Column (e)(3). Enter the number of shares constructively owned (within the meaning of section 958(b)) by the shareholder listed in column (a).

Section D—Disposition of Stock

Section D must be completed by shareholders who dispose of their interest (in whole or in part) in a foreign corporation.

Column (d). Enter the method of disposition (e.g., sale, bequest, gift, trade).

Example. In 1993, Mr. Jackson, a U.S. citizen, purchased 10,000 shares of common stock of foreign corporation X. The purchase represented 10% ownership of the foreign corporation.

On July 1, 2009, Mr. Jackson made a gift of 5,000 shares of foreign corporation X to his son, John. Because Mr. Jackson has reduced his holding in the foreign corporation, he is required to complete Form 5471 and Schedule O. To show the required information about the disposition, Mr. Jackson completes Section D as follows:

- Enters his name in column (a).
- Enters "common" in column (b).
- Enters "July 1, 2009" in column (c).
- Enters "gift" in column (d).
- Enters "5,000" in column (e)(1).
- Enters "-0-" in column (f) because the disposition was by gift.
- Enters the name and address of his son, John, in column (g).

Section F—Additional Information

Item (b). List the date of any reorganization of the foreign corporation that occurred during the last 4 years while any U.S. person held 10% or more in value or vote (directly or indirectly) of the corporation's stock. If there is more than one such date, use the most recent date. However, do not enter a date for which information was reported in Schedule E. Instead, enter the date (if any) of any reorganization prior to that date (if it is within the last 4 years).

Example for Item (c). Mr. Lyons, a U.S. person, acquires a 10% ownership in foreign corporation F. F is the 100% owner of two foreign corporations, FI and FJ. F is also a 50% owner of foreign corporation FK. In addition, F is 90% owned by foreign corporation W. Mr. Lyons does not own any of the stock of corporation W.

Mr. Lyons completes and files Form 5471 and Schedule O for the corporations in which he is a 10% or more shareholder. Mr. Lyons is also required to submit a chart if the foreign corporation is a member of a chain of corporations, and to indicate if he is a 10% or more shareholder in any of those corporations.

Mr. Lyons would prepare a list showing the corporations as follows:

- Corporation W
- Corporation F
- Corporation FI
- Corporation FJ
- Corporation FK

Then Mr. Lyons is required to indicate that he is a 10% or more shareholder in corporations F, FI, and FJ.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form and related schedules will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Form	Recordkeeping	Learning about the law or the form	Preparing and sending the form to the IRS
5471	82 hr., 45 min.	16 hr., 14 min.	24 hr., 17 min.
Sch. J (5471)	3 hr., 49 min.	1 hr., 29 min.	1 hr., 37 min.
Sch. M (5471)	26 hr., 33 min.	6 min.	32 min.
Sch. O (5471)	10 hr., 45 min.	24 min.	35 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form and related schedules simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

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Continued on next page

enterprise by the type of activity in which it is engaged to facilitate the administration of the [illegible] company purchases raw materials and supplies [illegible] description of the company's business activity

Code

Agriculture, Forestry, Fishing and Hunting

[illegible]
111210 Vegetable & Melon Farming (including potatoes & yams)
111300 Fruit & Tree Nut Farming
111400 Greenhouse, Nursery, & Floriculture Production
111900 Other Crop Farming (including tobacco, cotton, sugarcane, hay, peanut, sugar beet & all other crop farming)

Animal Production
112111 Beef Cattle Ranching & Farming
112112 Cattle Feedlots
112120 Dairy Cattle & Milk Production
112210 Hog & Pig Farming
112300 Poultry & Egg Production
112400 Sheep & Goat Farming
112510 Aquaculture (including shellfish & finfish farms & hatcheries)
112900 Other Animal Production

Forestry and Logging
113110 Timber Tract Operations
113210 Forest Nurseries & Gathering of Forest Products
113310 Logging

Fishing, Hunting and Trapping
114110 Fishing
114210 Hunting & Trapping

Support Activities for Agriculture and Forestry
115110 Support Activities for Crop Production (including cotton ginning, soil preparation, planting, & cultivating)
115210 Support Activities for Animal Production
115310 Support Activities For Forestry

Mining

211110 Oil & Gas Extraction
212110 Coal Mining
212200 Metal Ore Mining
212310 Stone Mining & Quarrying
212320 Sand, Gravel, Clay, & Ceramic & Refractory Minerals Mining & Quarrying
212390 Other Nonmetallic Mineral Mining & Quarrying
213110 Support Activities for Mining

Utilities

221100 Electric Power Generation, Transmission & Distribution
221210 Natural Gas Distribution
221300 Water, Sewage & Other Systems
221500 Combination Gas & Electric

Construction

Construction of Buildings
236110 Residential Building Construction
236200 Nonresidential Building Construction

Heavy and Civil Engineering Construction
237100 Utility System Construction
237210 Land Subdivision
237310 Highway, Street, & Bridge Construction

Code

237990 Other Heavy & Civil Engineering Construction

Specialty Trade Contractors
Building Exterior Contractors (including framing carpentry, masonry, glass, roofing, & siding)
238210 Electrical Contractors
238220 Plumbing, Heating, & Air-Conditioning Contractors
238290 Other Building Equipment Contractors
238300 Building Finishing Contractors (including drywall, insulation, painting, wallcovering, flooring, tile, & finish carpentry)
238900 Other Specialty Trade Contractors (including site preparation)

Manufacturing

Food Manufacturing
311110 Animal Food Mfg
311200 Grain & Oilseed Milling
311300 Sugar & Confectionery Product Mfg
311400 Fruit & Vegetable Preserving & Specialty Food Mfg
311500 Dairy Product Mfg
311610 Animal Slaughtering and Processing
311710 Seafood Product Preparation & Packaging
311800 Bakeries & Tortilla Mfg
311900 Other Food Mfg (including coffee, tea, flavorings & seasonings)

Beverage and Tobacco Product Manufacturing
312110 Soft Drink & Ice Mfg
312120 Breweries
312130 Wineries
312140 Distilleries
312200 Tobacco Manufacturing

Textile Mills and Textile Product Mills
313000 Textile Mills
314000 Textile Product Mills

Apparel Manufacturing
315100 Apparel Knitting Mills
315210 Cut & Sew Apparel Contractors
315220 Men's & Boys' Cut & Sew Apparel Mfg
315230 Women's & Girls' Cut & Sew Apparel Mfg
315290 Other Cut & Sew Apparel Mfg
315990 Apparel Accessories & Other Apparel Mfg

Leather and Allied Product Manufacturing
316110 Leather & Hide Tanning & Finishing
316210 Footwear Mfg (including rubber & plastics)
316990 Other Leather & Allied Product Mfg

Wood Product Manufacturing
321110 Sawmills & Wood Preservation
321210 Veneer, Plywood, & Engineered Wood Product Mfg
321900 Other Wood Product Mfg

Paper Manufacturing
322100 Pulp, Paper, & Paperboard Mills

Code

322200 Converted Paper Product Mfg

Printing and Related Support Activities
Activities

Petroleum and Coal Products Manufacturing
324110 Petroleum Refineries (including integrated)
324120 Asphalt Paving, Roofing, & Saturated Materials Mfg
324190 Other Petroleum & Coal Products Mfg

Chemical Manufacturing
325100 Basic Chemical Mfg
325200 Resin, Synthetic Rubber, & Artificial & Synthetic Fibers & Filaments Mfg
325300 Pesticide, Fertilizer, & Other Agricultural Chemical Mfg
325410 Pharmaceutical & Medicine Mfg
325500 Paint, Coating, & Adhesive Mfg
325600 Soap, Cleaning Compound, & Toilet Preparation Mfg
325900 Other Chemical Product & Preparation Mfg

Plastics and Rubber Products Manufacturing
326100 Plastics Product Mfg
326200 Rubber Product Mfg

Nonmetallic Mineral Product Manufacturing
327100 Clay Product & Refractory Mfg
327210 Glass & Glass Product Mfg
327300 Cement & Concrete Product Mfg
327400 Lime & Gypsum Product Mfg
327900 Other Nonmetallic Mineral Product Mfg

Primary Metal Manufacturing
331110 Iron & Steel Mills & Ferroalloy Mfg
331200 Steel Product Mfg from Purchased Steel
331310 Alumina & Aluminum Production & Processing
331400 Nonferrous Metal (except Aluminum) Production & Processing
331500 Foundries

Fabricated Metal Product Manufacturing
332110 Forging & Stamping
332210 Cutlery & Handtool Mfg
332300 Architectural & Structural Metals Mfg
332400 Boiler, Tank, & Shipping Container Mfg
332510 Hardware Mfg
332610 Spring & Wire Product Mfg
332700 Machine Shops; Turned Product; & Screw, Nut, & Bolt Mfg
332810 Coating, Engraving, Heat Treating, & Allied Activities
332900 Other Fabricated Metal Product Mfg

Machinery Manufacturing
333100 Agriculture, Construction, & Mining Machinery Mfg
333200 Industrial Machinery Mfg
333310 Commercial & Service Industry Machinery Mfg

Code

333410 Ventilation, Heating, Air-Conditioning, & Commercial Refrigeration
[illegible]
333610 Engine, Turbine & Power Transmission Equipment Mfg
333900 Other General Purpose Machinery Mfg

Computer and Electronic Product Manufacturing
334110 Computer & Peripheral Equipment Mfg
334200 Communications Equipment Mfg
334310 Audio & Video Equipment Mfg
334410 Semiconductor & Other Electronic Component Mfg
334500 Navigational, Measuring, Electromedical, & Control Instruments Mfg
334610 Manufacturing & Reproducing Magnetic & Optical Media

Electrical Equipment, Appliance, and Component Manufacturing
335100 Electric Lighting Equipment Mfg
335200 Household Appliance Mfg
335310 Electrical Equipment Mfg
335900 Other Electrical Equipment & Component Mfg

Transportation Equipment Manufacturing
336100 Motor Vehicle Mfg
336210 Motor Vehicle Body & Trailer Mfg
336300 Motor Vehicle Parts Mfg
336410 Aerospace Product & Parts Mfg
336510 Railroad Rolling Stock Mfg
336610 Ship & Boat Building
336990 Other Transportation Equipment Mfg

Furniture and Related Product Manufacturing
337000 Furniture & Related Product Manufacturing

Miscellaneous Manufacturing
339110 Medical Equipment & Supplies Mfg
339900 Other Miscellaneous Manufacturing

Wholesale Trade

Merchant Wholesalers, Durable Goods
423100 Motor Vehicle & Motor Vehicle Parts & Supplies
423200 Furniture & Home Furnishings
423300 Lumber & Other Construction Materials
423400 Professional & Commercial Equipment & Supplies
423500 Metal & Mineral (except Petroleum)
423600 Electrical & Electronic Goods
423700 Hardware, & Plumbing & Heating Equipment & Supplies
423800 Machinery, Equipment, & Supplies
423910 Sporting & Recreational Goods & Supplies
423920 Toy & Hobby Goods & Supplies
423930 Recyclable Materials

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Form 5471 (continued)

Code	
423940	Jewelry, Watch, Precious Stone, & Precious Metals
423990	Other Miscellaneous Durable Goods
Merchant Wholesalers, Nondurable Goods	
424100	Paper & Paper Products
424210	Drugs & Druggists' Sundries
424300	Apparel, Piece Goods, & Notions
424400	Grocery & Related Products
424500	Farm Product Raw Materials
424600	Chemical & Allied Products
424700	Petroleum & Petroleum Products
424800	Beer, Wine, & Distilled Alcoholic Beverages
424910	Farm Supplies
424920	Book, Periodical, & Newspapers
424930	Flower, Nursery Stock, & Florists' Supplies
424940	Tobacco & Tobacco Products
424950	Paint, Varnish, & Supplies
424990	Other Miscellaneous Nondurable Goods
Wholesale Electronic Markets and Agents and Brokers	
425110	Business to Business Electronic Markets
425120	Wholesale Trade Agents & Brokers

Retail Trade

Code	
Motor Vehicle and Parts Dealers	
441110	New Car Dealers
441120	Used Car Dealers
441210	Recreational Vehicle Dealers
441221	Motorcycle Dealers
441222	Boat Dealers
441229	All Other Motor Vehicle Dealers
441300	Automotive Parts, Accessories, & Tire Stores
Furniture and Home Furnishings Stores	
442110	Furniture Stores
442210	Floor Covering Stores
442291	Window Treatment Stores
442299	All Other Home Furnishings Stores
Electronics and Appliance Stores	
443111	Household Appliance Stores
443112	Radio, Television, & Other Electronics Stores
443120	Computer & Software Stores
443130	Camera & Photographic Supplies Stores
Building Material and Garden Equipment and Supplies Dealers	
444110	Home Centers
444120	Paint & Wallpaper Stores
444130	Hardware Stores
444190	Other Building Material Dealers
444200	Lawn & Garden Equipment & Supplies Stores
Food and Beverage Stores	
445110	Supermarkets and Other Grocery (except Convenience) Stores
445120	Convenience Stores
445210	Meat Markets
445220	Fish & Seafood Markets
445230	Fruit & Vegetable Markets
445291	Baked Goods Stores
445292	Confectionery & Nut Stores
445299	All Other Specialty Food Stores
445310	Beer, Wine, & Liquor Stores
Health and Personal Care Stores	
446110	Pharmacies & Drug Stores
446120	Cosmetics, Beauty Supplies, & Perfume Stores
446130	Optical Goods Stores
446190	Other Health & Personal Care Stores
Gasoline Stations	
447100	Gasoline Stations (including convenience stores with gas)
Clothing and Clothing Accessories Stores	
448110	Men's Clothing Stores
448120	Women's Clothing Stores
448130	Children's & Infants' Clothing Stores
448140	Family Clothing Stores
448150	Clothing Accessories Stores
448190	Other Clothing Stores
448210	Shoe Stores
448310	Jewelry Stores
448320	Luggage & Leather Goods Stores
Sporting Goods, Hobby, Book, and Music Stores	
451110	Sporting Goods Stores
451120	Hobby, Toy, & Game Stores
451130	Sewing, Needlework, & Piece Goods Stores
451140	Musical Instrument & Supplies Stores
451211	Book Stores
451212	News Dealers & Newsstands
451220	Prerecorded Tape, Compact Disc, & Record Stores
General Merchandise Stores	
452110	Department Stores
452900	Other General Merchandise Stores
Miscellaneous Store Retailers	
453110	Florists
453210	Office Supplies & Stationery Stores
453220	Gift, Novelty, & Souvenir Stores
453310	Used Merchandise Stores
453910	Pet & Pet Supplies Stores
453920	Art Dealers
453930	Manufactured (Mobile) Home Dealers
453990	All Other Miscellaneous Store Retailers (including tobacco, candle, & trophy shops)
Nonstore Retailers	
454110	Electronic Shopping & Mail-Order Houses
454210	Vending Machine Operators
454311	Heating Oil Dealers
454312	Liquefied Petroleum Gas (Bottled Gas) Dealers
454319	Other Fuel Dealers
454390	Other Direct Selling Establishments (including door-to-door retailing, frozen food plan providers, party plan merchandisers, & coffee-break service providers)

Transportation and Warehousing

Code	
Air, Rail, and Water Transportation	
481000	Air Transportation
482110	Rail Transportation
483000	Water Transportation
Truck Transportation	
484110	General Freight Trucking, Local
484120	General Freight Trucking, Long-distance
484200	Specialized Freight Trucking
Transit and Ground Passenger Transportation	
485110	Urban Transit Systems
485210	Interurban & Rural Bus Transportation
485310	Taxi Service
485320	Limousine Service
485410	School & Employee Bus Transportation
485510	Charter Bus Industry
485990	Other Transit & Ground Passenger Transportation
Pipeline Transportation	
486000	Pipeline Transportation
Scenic & Sightseeing Transportation	
487000	Scenic & Sightseeing Transportation
Support Activities for Transportation	
488100	Support Activities for Air Transportation
488210	Support Activities for Rail Transportation
488300	Support Activities for Water Transportation
488410	Motor Vehicle Towing
488490	Other Support Activities for Road Transportation
488510	Freight Transportation Arrangement
488990	Other Support Activities for Transportation
Couriers and Messengers	
492110	Couriers
492210	Local Messengers & Local Delivery
Warehousing and Storage	
493100	Warehousing & Storage (except lessors of miniwarehouses & self-storage units)

Information

Code	
Publishing Industries (except Internet)	
511110	Newspaper Publishers
511120	Periodical Publishers
511130	Book Publishers
511140	Directory & Mailing List Publishers
511190	Other Publishers
511210	Software Publishers
Motion Picture and Sound Recording Industries	
512100	Motion Picture & Video Industries (except video rental)
512200	Sound Recording Industries
Broadcasting (except Internet)	
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
Telecommunications	
517000	Telecommunications (including paging, cellular, satellite, cable & other program distribution, resellers, other telecommunications, & internet service providers)
Data Processing Services	
518210	Data Processing, Hosting, & Related Services
Other Information Services	
519100	Other Information Services (including news syndicates, libraries, internet publishing & broadcasting)

Finance and Insurance

Code	
Depository Credit Intermediation	
522110	Commercial Banking
522120	Savings Institutions
522130	Credit Unions
522190	Other Depository Credit Intermediation
Nondepository Credit Intermediation	
522210	Credit Card Issuing
522220	Sales Financing
522291	Consumer Lending
522292	Real Estate Credit (including mortgage bankers & originators)
522293	International Trade Financing
522294	Secondary Market Financing
522298	All Other Nondepository Credit Intermediation
Activities Related to Credit Intermediation	
522300	Activities Related to Credit Intermediation (including loan brokers, check clearing, & money transmitting)
Securities, Commodity Contracts, and Other Financial Investments and Related Activities	
523110	Investment Banking & Securities Dealing
523120	Securities Brokerage
523130	Commodity Contracts Dealing
523140	Commodity Contracts Brokerage
523210	Securities & Commodity Exchanges
523900	Other Financial Investment Activities (including portfolio management & investment advice)
Insurance Carriers and Related Activities	
524140	Direct Life, Health, & Medical Insurance & Reinsurance Carriers
524150	Direct Insurance & Reinsurance (except Life, Health & Medical) Carriers
524210	Insurance Agencies & Brokerages
524290	Other Insurance Related Activities (including third-party administration of insurance and pension funds)
Funds, Trusts, and Other Financial Vehicles	
525100	Insurance & Employee Benefit Funds
525910	Open-End Investment Funds (Form 1120-RIC)
525920	Trusts, Estates, & Agency Accounts
525990	Other Financial Vehicles (including mortgage REITs & closed-end investment funds)

"Offices of Bank Holding Companies" and "Offices of Other Holding Companies" are located under **Management of Companies (Holding Companies)** on page 16.

Real Estate and Rental and Leasing

Code	
Real Estate	
531110	Lessors of Residential Buildings & Dwellings (including equity REITs)
531114	Cooperative Housing (including equity REITs)
531120	Lessors of Nonresidential Buildings (except Miniwarehouses) (including equity REITs)
531130	Lessors of Miniwarehouses & Self-Storage Units (including equity REITs)
531190	Lessors of Other Real Estate Property (including equity REITs)
531210	Offices of Real Estate Agents & Brokers
531310	Real Estate Property Managers
531320	Offices of Real Estate Appraisers
531390	Other Activities Related to Real Estate

Instructions for Form 5471 -15-

Continued on next page

& Leasing

532210 Consumer Electronics & Appliances Rental

532220 Formal Wear & Costume Rental

532230 Video Tape & Disc Rental

532290 Other Consumer Goods Rental

532310 General Rental Centers

532400 Commercial & Industrial Machinery & Equipment Rental & Leasing

Lessors of Nonfinancial Intangible Assets (except copyrighted works)

533110 Lessors of Nonfinancial Intangible Assets (except copyrighted works)

Professional, Scientific, and Technical Services

Legal Services

541110 Offices of Lawyers

541190 Other Legal Services

Accounting, Tax Preparation, Bookkeeping, and Payroll Services

541211 Offices of Certified Public Accountants

541213 Tax Preparation Services

541214 Payroll Services

541219 Other Accounting Services

Architectural, Engineering, and Related Services

541310 Architectural Services

541320 Landscape Architecture Services

541330 Engineering Services

541340 Drafting Services

541350 Building Inspection Services

541360 Geophysical Surveying & Mapping Services

541370 Surveying & Mapping (except Geophysical) Services

541380 Testing Laboratories

Specialized Design Services

541400 Specialized Design Services (including interior, industrial, graphic, & fashion design)

Computer Systems Design and Related Services

541511 Custom Computer Programming Services

541512 Computer Systems Design Services

541513 Computer Facilities Management Services

541519 Other Computer Related Services

Other Professional, Scientific, and Technical Services

541600 Management, Scientific, & Technical Consulting Services

541700 Scientific Research & Development Services

541800 Advertising & Related Services

541910 Marketing Research & Public Opinion Polling

541920 Photographic Services

541930 Translation & Interpretation Services

541940 Veterinary Services

541990 All Other Professional, Scientific, & Technical Services

(Holding Companies)

551111 Offices of Bank Holding Companies

551112 Offices of Other Holding Companies

Administrative and Support and Waste Management and Remediation Services

Administrative and Support Services

561110 Office Administrative Services

561210 Facilities Support Services

561300 Employment Services

561410 Document Preparation Services

561420 Telephone Call Centers

561430 Business Service Centers (including private mail centers & copy shops)

561440 Collection Agencies

561450 Credit Bureaus

561490 Other Business Support Services (including repossession services, court reporting, & stenotype services)

561500 Travel Arrangement & Reservation Services

561600 Investigation & Security Services

561710 Exterminating & Pest Control Services

561720 Janitorial Services

561730 Landscaping Services

561740 Carpet & Upholstery Cleaning Services

561790 Other Services to Buildings & Dwellings

561900 Other Support Services (including packaging & labeling services, & convention & trade show organizers)

Waste Management and Remediation Services

562000 Waste Management & Remediation Services

Educational Services

611000 Educational Services (including schools, colleges, & universities)

Health Care and Social Assistance

Offices of Physicians and Dentists

621111 Offices of Physicians (except mental health specialists)

621112 Offices of Physicians, Mental Health Specialists

621210 Offices of Dentists

Offices of Other Health Practitioners

621310 Offices of Chiropractors

621320 Offices of Optometrists

621330 Offices of Mental Health Practitioners (except Physicians)

621340 Offices of Physical, Occupational & Speech Therapists, & Audiologists

621391 Offices of Podiatrists

621399 Offices of All Other Miscellaneous Health Practitioners

621420 Outpatient Mental Health & Substance Abuse Centers

621491 HMO Medical Centers

621492 Kidney Dialysis Centers

621493 Freestanding Ambulatory Surgical & Emergency Centers

621498 All Other Outpatient Care Centers

Medical and Diagnostic Laboratories

621510 Medical & Diagnostic Laboratories

Home Health Care Services

621610 Home Health Care Services

Other Ambulatory Health Care Services

621900 Other Ambulatory Health Care Services (including ambulance services & blood & organ banks)

Hospitals

622000 Hospitals

Nursing and Residential Care Facilities

623000 Nursing & Residential Care Facilities

Social Assistance

624100 Individual & Family Services

624200 Community Food & Housing, & Emergency & Other Relief Services

624310 Vocational Rehabilitation Services

624410 Child Day Care Services

Arts, Entertainment, and Recreation

Performing Arts, Spectator Sports, and Related Industries

711100 Performing Arts Companies

711210 Spectator Sports (including sports clubs & racetracks)

711300 Promoters of Performing Arts, Sports, & Similar Events

711410 Agents & Managers for Artists, Athletes, Entertainers, & Other Public Figures

711510 Independent Artists, Writers, & Performers

Museums, Historical Sites, and Similar Institutions

712100 Museums, Historical Sites, & Similar Institutions

Amusement, Gambling, and Recreation Industries

713100 Amusement Parks & Arcades

713200 Gambling Industries

713900 Other Amusement & Recreation Industries (including golf courses, skiing facilities, marinas, fitness centers, & bowling centers)

Accommodation and Food Services

Accommodation

721110 Hotels (except Casino Hotels) & Motels

721120 Casino Hotels

721191 Bed & Breakfast Inns

721210 RV (Recreational Vehicle) Parks & Recreational Camps

721310 Rooming & Boarding Houses

Food Services and Drinking Places

722110 Full-Service Restaurants

722210 Limited-Service Eating Places

722300 Special Food Services (including food service contractors & caterers)

722410 Drinking Places (Alcoholic Beverages)

Other Services

Repair and Maintenance

811110 Automotive Mechanical & Electrical Repair & Maintenance

811120 Automotive Body, Paint, Interior, & Glass Repair

811190 Other Automotive Repair & Maintenance (including oil change & lubrication shops & car washes)

811210 Electronic & Precision Equipment Repair & Maintenance

811310 Commercial & Industrial Machinery & Equipment (except Automotive & Electronic) Repair & Maintenance

811410 Home & Garden Equipment & Appliance Repair & Maintenance

811420 Reupholstery & Furniture Repair

811430 Footwear & Leather Goods Repair

811490 Other Personal & Household Goods Repair & Maintenance

Personal and Laundry Services

812111 Barber Shops

812112 Beauty Salons

812113 Nail Salons

812190 Other Personal Care Services (including diet & weight reducing centers)

812210 Funeral Homes & Funeral Services

812220 Cemeteries & Crematories

812310 Coin-Operated Laundries & Drycleaners

812320 Drycleaning & Laundry Services (except Coin-Operated)

812330 Linen & Uniform Supply

812910 Pet Care (except Veterinary) Services

812920 Photofinishing

812930 Parking Lots & Garages

812990 All Other Personal Services

Religious, Grantmaking, Civic, Professional, and Similar Organizations

813000 Religious, Grantmaking, Civic, Professional, & Similar Organizations (including condominium and homeowners associations)

-16- Instructions for Form 5471

Exhibit 17A – 3, *Chief Counsel Advice 200748006*

IRS CCA 200748006, 2007 WL 4217452 (IRS CCA)

Internal Revenue Service (I.R.S.)
IRS CCA

Chief Counsel Advice

Issue: November 30, 2007
October 30, 2007

Section 6038 -- Information With Respect to Certain Foreign Corporations6038.00-00 Information with Respect to Certain Foreign Corporations and Partnerships

6038.02-00 Dollar Penalty for Failure to Furnish Information

6038.03-00 Penalty of Reducing Foreign Tax Credit

CC:INTL:B02:KTHolman
FILEN-128339-07

to: (Chief, Business Adjustment Section) SE:W:CAS:AM:PPG:B

from: Phyllis E. Marcus (Chief, International Branch 2) CC:INTL:B02

subject: Legality of Abatement of Civil Penalties Under Section 6038

This is in response to your request that we provide advice as to whether the same criteria used for a reasonable cause determination made by Accounts Management (AM) for abatement of the section 6651(a) (1) failure to file penalty with respect to a late Form 1120 can be used for the abatement of the section 6038 civil penalty with respect to a late Form 5471.

BACKGROUND

Section 6012(a) (2) of subchapter A of chapter 61 requires every corporation subject to taxation under subtitle A to file a return with respect to income taxes. Form 1120 is used for corporate income tax reporting and to comply with section 6012(a) (2). All domestic corporations generally must file Form 1120. Section 6651(a) (1) imposes a penalty for failure to file any return on the date prescribed (including any extension of time for filing) unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

Continued on next page

Form 5471 is a return used by certain U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations in order to satisfy their reporting obligations under sections 6038 and 6046 and the related regulations. Form 5471 is used for information reporting, not tax reporting. Dollar penalties and penalties of reduced foreign tax credits are imposed under section 6038(b) and (c) for failure to file the information required by section 6038(a) within the time prescribed. Section 6038 (c) (4) provides that for purposes of the section 6038(b) and (c) penalties, the time prescribed under section 6038(a) (2) to furnish information (and the beginning of the 90-day period after notice by the Secretary) shall be treated as being not earlier than the last day on which (as shown to the satisfaction of the Secretary) reasonable cause existed for failure to furnish such information. Section 6038 does not include a provision defining reasonable cause for failure to furnish the required information within the time prescribed.

ANALYSIS

Reasonable cause is based on all the facts and circumstances in each situation and allows the Service to provide relief from a penalty that would otherwise be assessed. Relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but is unable to comply with those obligations. See IRM 20.1.1.3.1(1). Nonassertion or abatement of civil penalties based on reasonable cause must be made in a consistent manner. See IRM 20.1.1.3.1(2). The language of reasonable cause provisions vary. Some penalty provisions also require evidence that the taxpayer acted in good faith (e.g. section 6664(c) (1)) or that the taxpayer's failure to comply with the law was not due to willful neglect (e.g. section 6651(a) (1)). The section 6038 reasonable cause provision does not include the additional requirement “and not due to willful neglect” that is part of the section 6651 reasonable cause provision.

Failure to file a Form 1120 within the prescribed time ordinarily generates a section 6651(a) (1) penalty unless the taxpayer satisfies the applicable reasonable cause standard. As noted above, section 6651 imposes a penalty *unless it is shown that the failure is due to reasonable cause and not due to willful neglect*. Treas. Reg. § 301.6651-1(c) discusses a showing of reasonable cause for purposes of the failure to file penalty and provides that if the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause.

Continued on next page

Failure to file a Form 5471 information return generates penalties under section 6038. Neither the statute, nor the regulations under section 6038, defines reasonable cause for failure to timely file a Form 5471. IRM 20.1.1, as well as other analogous regulations (e.g. Treas. Reg. § 301.6651-1(c)) suggest standards for evaluating reasonable cause. IRM 20.1.1.3.1.2(2) provides factors to consider to determine whether the taxpayer exercised ordinary business care and prudence. Those factors include taxpayers' reasons, compliance history, length of time, circumstances beyond the taxpayers control, and in some cases ignorance of the law or inability to get records. It is our understanding that AM's decision tree for imposing penalties for late filing of Form 1120 is based upon such factors.

The reasonable cause standard mandated by section 6651 requires the taxpayer to affirmatively establish that the failure was due to reasonable cause and not willful neglect. Although taxpayers are not required to demonstrate that failure to file was not due to willful neglect for Form 5471, the considerations (e.g. exercise of ordinary business care and prudence) discussed above would constitute valid considerations for abating a failure to file timely Forms 5471. Also, there should be consistency in applying the penalty if a taxpayer failed to file both its Form 1120 and the Form 5471.

CONCLUSION

We conclude there is no legal rule or internal policy prohibiting AM from using the same criteria to abate the section 6038 penalty for a late filing of Form 5471 where AM has abated the section 6651(a)(1) failure to file penalty for the late Form 1120 using the reasonable cause criteria in IRM 20.1.1.3.1. Also, there is no legal reason why the same criteria could not be used even where the Form 1120 was timely filed, but the Form 5471 was not. The irrelevance of reasonable cause with respect to one form does not preclude a reasonable cause determination with respect to the other form. Thus, for example, if the Form 1120 was timely filed, but the Form 5471 was not, a reasonable cause determination may be made with respect to the failure to file Form 5471 even though reasonable cause is irrelevant with respect to the timely filed Form 1120.

IRS CCA 200748006, 2007 WL 4217452 (IRS CCA)

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200748006

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International Technical Training

Chapter 17B

Form 5472 – Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• Two Hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and examples
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide

Overview

Instructor Notes

This chapter presents some basic concepts related to the filing of Form 5472. At the end of the lesson, the student should come away with some basic, but important, understanding of the purpose of the form, who is required to file this form, and what to look for in the examination process.

Introduction

In this chapter, we will discuss Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or business*. The form and the related instructions are only 4 pages but contain a lot of information. It is used to satisfy the reporting requirements of sections 6038A and 6038C, and captures transactional information between the reporting corporation and foreign related party.

Objective

At the end of this chapter:

- The student will be able to understand the purpose of Form 5472 and know the basics of what to look for in the examination process.

Continued on next page

Contents

This lesson covers the following topics:

Filing Requirement

Reading Assignment

- IRC § 6038A, § 6038C.
- Treas. Reg. § 1.6038A-1(c) (1).

Generally, a reporting corporation must file Form 5472 *if* it had a reportable transaction with a foreign or domestic related party. In other words, if the reporting corporation had *no* reportable transaction with respect to each foreign or domestic related party, Form 5472 is not required. Reportable transactions will be discussed later in the chapter.

There are other exceptions from filing. In-depth discussion of each exception is beyond the scope of this lesson. However, the form instructions under "Who Must File" provide some details to the exceptions.

Definitions of Reporting Corporation

A reporting corporation is either:

1. A 25% foreign-owned U.S. corporation, or
2. A foreign corporation engaged in a trade or business within the United States.

Continued on next page

Additional Definition

25% foreign-owned means there is at least one direct or indirect 25% foreign shareholder at any time during the year.

A foreign person is a 25% foreign shareholder if it owns at least 25% of the stock of the reporting corporation, either by value or by vote.

The foreign shareholder can own directly or indirectly through the attribution rules of § 318.

Example 17B – 1

Ali, a foreign person, owns 20% of Complex, Inc., a U.S. corporation. Ali's wife, Nadine, owns 5% of Complex, Inc. By attribution, Ali and Nadine own, in aggregate, 25% of Complex, Inc. Complex, Inc., therefore, is a Reporting Corporation and is required to file Form 5472, assuming there were reportable transactions during the year.

Related Party

Reading Assignment

Treas. Reg. § 1.6038A-1(d).

Previously, we defined what is a reporting corporation. We also said a reporting corporation is required to file Form 5472 *only* if it had a reportable transaction with respect to each foreign or domestic related party. In this section, we will cover the definition of a related party, both foreign and domestic.

A related party under Treas. Reg. § 1.6038A-1(d) is:

1. Any direct or indirect 25% foreign shareholder of the reporting corporation, or
2. Any person who is related within the meaning of § 267(b) or § 707(b)(1) to the reporting corporation or to a 25% foreign shareholder of the reporting corporation, or
3. Any other person who is related to the reporting corporation within the meaning of § 482 and the regulations thereunder;
4. However, a related party here does *not* include any corporation filing a consolidated tax return with the reporting corporation.

Example 17B – 2

Joe, a U.S. individual owns 50% of Complex, Inc., a reporting corporation. Joes is not a related party within the meaning of § 267(b).

Example 17B – 3

Joe, from example 2, is the brother of the 25% foreign shareholder of the reporting corporation. Joe is a related party to Complex, Inc. within the meaning of § 267(b). Assuming there are reportable transactions between Joe and Complex, Inc., Form 5472 must be filed.

Continued on next page

Form 5472

Form 5472 is often filed with Form 1120-F, U.S. Income Tax Return of a Foreign Corporation (See page 1 of Form 1120-F in the exhibit section).

Form 5472 is often filed with Form 1120, U.S. Corporation Income Tax Return (See page 4 of Form 1120 in the exhibit section).

Part III of Form 5472 is where the related party, whether foreign or U.S., is identified. The completion of part III is mandatory.

Reportable Transaction

Reading Assignment

Treas. Reg. § 1.6038A-2(b) (3) & (4).

Form 5472 Part IV, V

Reportable transaction is any transaction with a foreign related party listed in the regulations in which monetary or non-monetary consideration is paid or received by the reporting corporation. All amounts should be stated in U.S. dollars and a schedule should be attached to show the exchange rates used.

The types of transactions are listed in part IV of the form. The transactions are looked at from the perspective of the reporting corporation. For example, line 7 reports amounts borrowed by the reporting corporation from the foreign related party. Line 18 reports amounts loaned by the reporting corporation to the foreign related party.

Form 5472 instructions provide further guidance in completing these parts of the form.

Some Audit Considerations

A. Compare information reported in Part IV and Part V of Form 5472 to the financial statements of the reporting corporation.

B. Make sure the financial statements conform to U.S. accounting standards if the reporting corporation is a foreign entity.

C. Review the organization's bylaws, articles of incorporation, minutes, stock certificates, organization charts, etc. to verify relationships between the reporting corporation and related parties (foreign and domestic).

D. Be alert to tax ramifications when reviewing the reportable transactions. Question whether the loans between the related parties are bona-fide loans or disguised dividends. If there are sales between related parties, question whether these sales are sourced to the U.S. and reported as U.S. taxable income.

E. Compare current Form(s) 5472with prior and subsequent years and verify any changes in the organization structure and/or related party relationships.

F. Review any exchange rates used by the reporting corporation for reasonableness.

Non-Compliance Penalties

A. Unlike Form 5471, a duplicate copy of Form 5472 must be filed separately with the IRS Center in Philadelphia.

B. Also, unlike Form 5472, non-filing penalty can be unlimited, unless there is reasonable cause (See Treas. Reg. § 1.6038A-4(b)).

C. Penalty starts at $10,000 and increases by $10,000 increments until compliance (See Treas. Reg. § 1.6038A-4(d)).

   See IRS letter 3806 in the exhibit section. This letter is a notification to the taxpayer for failure to comply with filing requirement.

D. A reporting corporation is subject to a penalty if:
   1. It fails to timely file a Form 5472.
   2. It fails to file a substantially completed Form 5472.
   3. It fails to maintain records as described in Treas. Reg. § 1.6038A-3(a).
   4. It fails to comply with the foreign related party record maintenance requirements described in Treas. Reg. § 1.6038A-3(b) & (c).

E. Statute of limitations on any “tax assessment” does not begin to run until the date on which the IRS is furnished with all of the required information under § 6501(c) (8). However, there is no SOL on the period of assessment of the monetary penalties discussed above.

Exhibits

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Form **5472**

(Rev. December 2007)

Department of the Treasury
Internal Revenue Service

Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

(Under Sections 6038A and 6038C of the Internal Revenue Code)

For tax year of the reporting corporation beginning ________ , ____, and ending ________ , ____

Note. *Enter all information in English and money items in U.S. dollars.*

often filed w/ 1120-F

OMB No. 1545-0805

Part I **Reporting Corporation** (see instructions). All reporting corporations must complete Part I.

1a Name of reporting corporation

1b Employer identification number

Number, street, and room or suite no. (if a P.O. box, see instructions)

1c Total assets

$

City or town, state, and ZIP code (if a foreign address, see instructions)

1d Principal business activity ▶

1e Principal business activity code ▶

1f Total value of gross payments made or received (see instructions) reported on **this** Form 5472
$

1g Total number of Forms 5472 filed for the tax year

1h Total value of gross payments made or received (see instructions) reported on **all** Forms 5472
$

1i Check here if this is a consolidated filing of Form 5472 . . . ▶ ☐

1j Country of incorporation

1k Country(ies) under whose laws the reporting corporation files an income tax return as a resident

1l Principal country(ies) where business is conducted

2 Check here if, at any time during the tax year, any foreign person owned, directly or indirectly, at least 50% of **(a)** the total voting power of all classes of the stock of the reporting corporation entitled to vote, or **(b)** the total value of all classes of stock of the reporting corporation . . . . ▶ ☐

Part II **25% Foreign Shareholder** (see instructions)

1a Name and address of direct 25% foreign shareholder

1b U.S. identifying number, if any

1c Principal country(ies) where business is conducted

1d Country of citizenship, organization, or incorporation

1e Country(ies) under whose laws the direct 25% foreign shareholder files an income tax return as a resident

2a Name and address of direct 25% foreign shareholder

2b U.S. identifying number, if any

2c Principal country(ies) where business is conducted

2d Country of citizenship, organization, or incorporation

2e Country(ies) under whose laws the direct 25% foreign shareholder files an income tax return as a resident

3a Name and address of ultimate indirect 25% foreign shareholder

3b U.S. identifying number, if any

3c Principal country(ies) where business is conducted

3d Country of citizenship, organization, or incorporation

3e Country(ies) under whose laws the ultimate indirect 25% foreign shareholder files an income tax return as a resident

4a Name and address of ultimate indirect 25% foreign shareholder

4b U.S. identifying number, if any

4c Principal country(ies) where business is conducted

4d Country of citizenship, organization, or incorporation

4e Country(ies) under whose laws the ultimate indirect 25% foreign shareholder files an income tax return as a resident

Part III **Related Party** (see instructions)
Check applicable box: Is the related party a ☐ foreign person or ☐ U.S. person?
All reporting corporations must complete this question and the rest of Part III.

1a Name and address of related party

1b U.S. identifying number, if any

1c Principal business activity ▶

1d Principal business activity code ▶

1e Relationship—Check boxes that apply: ☐ Related to reporting corporation ☐ Related to 25% foreign shareholder ☐ 25% foreign shareholder

1f Principal country(ies) where business is conducted

1g Country(ies) under whose laws the related party files an income tax return as a resident

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Continued on next page

If estimates are used, check here ▶ ☐

1	Sales of stock in trade (inventory)	1	
2	Sales of tangible property other than stock in trade	2	
3a	Rents received (for other than intangible property rights)	3a	
b	Royalties received (for other than intangible property rights)	3b	
4	Sales, leases, licenses, etc., of intangible property rights (e.g., patents, trademarks, secret formulas)	4	
5	Consideration received for technical, managerial, engineering, construction, scientific, or like services	5	
6	Commissions received	6	
7	Amounts borrowed (see instructions) **a** Beginning balance ______ **b** Ending balance or monthly average ▶	7b	
8	Interest received	8	
9	Premiums received for insurance or reinsurance	9	
10	Other amounts received (see instructions)	10	
11	**Total.** Combine amounts on lines 1 through 10	11	
12	Purchases of stock in trade (inventory)	12	
13	Purchases of tangible property other than stock in trade	13	
14a	Rents paid (for other than intangible property rights)	14a	
b	Royalties paid (for other than intangible property rights)	14b	
15	Purchases, leases, licenses, etc., of intangible property rights (e.g., patents, trademarks, secret formulas)	15	
16	Consideration paid for technical, managerial, engineering, construction, scientific, or like services	16	
17	Commissions paid	17	
18	Amounts loaned (see instructions) **a** Beginning balance ______ **b** Ending balance or monthly average ▶	18b	
19	Interest paid	19	
20	Premiums paid for insurance or reinsurance	20	
21	Other amounts paid (see instructions)	21	
22	**Total.** Combine amounts on lines 12 through 21	22	

Part V **Nonmonetary and Less-Than-Full Consideration Transactions Between the Reporting Corporation and the Foreign Related Party** (see instructions)

Describe these transactions on an attached separate sheet and check here. ▶ ☐

Part VI **Additional Information**

All reporting corporations must complete Part VI.

1 Does the reporting corporation import goods from a foreign related party? ☐ Yes ☐ No

2a If "Yes," is the basis or inventory cost of the goods valued at greater than the customs value of the imported goods? ☐ Yes ☐ No
If "No," **do not** complete **b** and **c** below.

b If "Yes," attach a statement explaining the reason or reasons for such difference.

c If the answers to questions 1 and 2a are "Yes," were the documents used to support this treatment of the imported goods in existence and available in the United States at the time of filing Form 5472? ☐ Yes ☐ No

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

- The IRS has modified Part IV, lines 3 and 14.
- A reporting corporation that uses an accrual method of accounting must use accrued payments and accrued receipts for purposes of computing the total amount to enter on each line of the Form 5472. See Regulations section 1.6038A-2(b)(8).

Purpose of Form

Use Form 5472 to provide information required under sections 6038A and 6038C when reportable transactions occur during the tax year of a reporting corporation with a foreign or domestic related party.

Definitions

Reporting corporation. A reporting corporation is either:

- A 25% foreign-owned U.S. corporation **or**
- A foreign corporation engaged in a trade or business within the United States.

25% foreign owned. A corporation is 25% foreign owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year.

25% foreign shareholder. Generally, a foreign person (defined on page 3) is a 25% foreign shareholder if the person owns, directly or indirectly, at least 25% of either:

- The total voting power of all classes of stock entitled to vote **or**
- The total value of all classes of stock of the corporation.

The constructive ownership rules of section 318 apply with the following modifications to determine if a corporation is 25% foreign owned. Substitute "10%" for "50%" in section 318(a)(2)(C). Do not apply sections 318(a)(3)(A), (B), and (C) so as to consider a U.S. person as owning stock that is owned by a foreign person.

Related party. A related party is:

- Any direct or indirect 25% foreign shareholder of the reporting corporation,
- Any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the reporting corporation,
- Any person who is related (within the meaning of section 267(b) or 707(b)(1)) to a 25% foreign shareholder of the reporting corporation, **or**
- Any other person who is related to the reporting corporation within the meaning of section 482 and the related regulations.

"Related party" does not include any corporation filing a consolidated Federal income tax return with the reporting corporation.

The rules in section 318 apply to the definition of related party with the modifications listed under the definition of *25% foreign shareholder* above.

Continued on next page

Reportable transaction. A reportable transaction is:

- Any type of transaction listed in Part IV (e.g., sales, rents, etc.) for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the reporting corporation's tax year **or**
- Any transaction or group of transactions listed in Part IV, if:

1. Any part of the consideration paid or received was not monetary consideration **or**

2. Less than full consideration was paid or received.

Transactions with a U.S. related party, however, are not required to be specifically identified in Parts IV and V.

Direct 25% foreign shareholder. A foreign person is a direct 25% foreign shareholder if it owns directly at least 25% of the stock of the reporting corporation by vote or value.

Ultimate indirect 25% foreign shareholder. An ultimate indirect 25% foreign shareholder is a 25% foreign shareholder whose ownership of stock of the reporting corporation is not attributed (under the principles of section 958(a)(1) and (2)) to any other 25% foreign shareholder. See Rev. Proc. 91-55, 1991-2 C.B. 784.

Foreign person. A foreign person is:

- An individual who is not a citizen or resident of the United States,
- An individual who is a citizen or resident of a U.S. possession who is not otherwise a citizen or resident of the United States,
- Any partnership, association, company, or corporation that is not created or organized in the United States,
- Any foreign estate or foreign trust described in section 7701(a)(31), **or**
- Any foreign government (or agency or instrumentality thereof) to the extent that the foreign government is engaged in the conduct of a commercial activity as defined in section 892.

However, the term "foreign person" does not include any foreign person who consents to the filing of a joint income tax return.

Who Must File

Generally, a reporting corporation must file Form 5472 if it had a reportable transaction with a foreign or domestic related party.

Exceptions from filing. A reporting corporation is not required to file Form 5472 if any of the following apply:

1. It had no reportable transactions of the types listed in Parts IV and V of the form.

2. A U.S. person that controls the foreign related corporation files **Form 5471,** Information Return of U.S. Persons With Respect To Certain Foreign Corporations, for the tax year to report information under section 6038. To qualify for this exception, the U.S. person must complete Schedule M (Form 5471) showing all reportable transactions between the reporting corporation and the related party for the tax year.

3. The related corporation qualifies as a foreign sales corporation for the tax year and files **Form 1120-FSC,** U.S. Income Tax Return of a Foreign Sales Corporation.

4. It is a foreign corporation that does not have a permanent establishment in the United States under an applicable income tax treaty and timely files Form 8833.

5. It is a foreign corporation all of whose gross income is exempt from taxation under section 883 and it timely and fully complies with the reporting requirements of sections 883 and 887.

6. Both the reporting corporation and the related party are not U.S. persons as defined in section 7701(a)(30) and the transactions will not generate in any tax year:

- Gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States **or**
- Any expense, loss, or other deduction that is allocable or apportionable to such income.

Consolidated returns. If a reporting corporation is a member of an affiliated group filing a consolidated income tax return, Regulations section 1.6038A-2 may be satisfied by filing a U.S. consolidated Form 5472. The common parent must attach to Form 5472 a schedule stating which members of the U.S. affiliated group are reporting corporations under section 6038A, and which of those members are joining in the consolidated filing of Form 5472. The schedule must show the name, address, and employer identification number of each member who is including transactions on the consolidated Form 5472.

Note. *A member is not required to join in filing a consolidated Form 5472 just because the other members of the group choose to file one or more Forms 5472 on a consolidated basis.*

When and Where To File

File Form 5472 by the due date of the reporting corporation's income tax return (including extensions). A separate Form 5472 must be filed for each foreign or domestic related party with which the reporting corporation had a reportable transaction during the tax year. Attach Form 5472 to the income tax return. You are required to file a duplicate copy of Form 5472 with the Internal Revenue Service Center, P.O. Box 409101, Ogden, UT, 84409. However, if you file your income tax return electronically, see *Electronic Filing of Form 5472* below for additional information.

If the reporting corporation's income tax return is not filed when due, file a timely Form 5472 (with a copy to Ogden) separately with the service center where the tax return is due. When the tax return is filed, attach a copy of the previously filed Form 5472.

Electronic Filing of Form 5472

If you file your income tax return electronically, see the instructions for your income tax return for general information about electronic filing. If you file your original Form 5472 electronically (as an attachment to a timely filed, electronically filed income tax return), such filing satisfies the duplicate filing requirement referred to above. See the first sentence under *When and Where To File* above for the definition of "timely."

Accrued Payments and Receipts

A reporting corporation that uses an accrual method of accounting must use accrued payments and accrued receipts for purposes of computing the total amount to enter on each line of the Form 5472. See Regulations section 1.6038A-2(b)(8).

Penalties

Penalties for failure to file Form 5472. A penalty of $10,000 will be assessed on any reporting corporation that fails to file Form 5472 when due and in the manner prescribed. The penalty also applies for failure to maintain records as required by Regulations section 1.6038A-3.

Note. *Filing a substantially incomplete Form 5472 constitutes a failure to file Form 5472.*

Each member of a group of corporations filing a consolidated information return is a separate reporting corporation subject to a separate $10,000 penalty and each member is jointly and severally liable.

If the failure continues for more than 90 days after notification by the IRS, an additional penalty of $10,000 will apply. This penalty applies with respect to each related party for which a failure occurs for each 30-day period (or part of a 30-day period) during which the failure continues after the 90-day period ends.

Criminal penalties under sections 7203, 7206, and 7207 may also apply for failure to submit information or for filing false or fraudulent information.

Record Maintenance Requirements

A reporting corporation must keep the permanent books of account or records as required by section 6001. These books must be sufficient to establish the correctness of the reporting corporation's Federal income tax return, including information or records that might be relevant to determine the correct treatment of transactions with related parties. See Regulations section 1.6038A-3 for more detailed information. Also, see Regulations sections 1.6038A-1(h) and 1.6038A-1(i) for special rules that apply to small corporations and reporting corporations with related party transactions of de minimis value.

Specific Instructions

Part I

Line 1a. Address. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the corporation has a P.O. box, show the box number instead.

Foreign address. Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code, if any. Do not abbreviate the country name.

Line 1c. Total assets. Domestic reporting corporations enter the total assets from item D, page 1, Form 1120. Foreign reporting corporations enter the amount from line 17, column (d), Schedule L, Form 1120-F.

Lines 1d and 1e. Enter a description of the principal business activity and enter the principal business activity code. See the instructions for Form 1120 or Form 1120-F for a list of principal business activities and their associated codes.

Line 1f. Enter the total value in U.S. dollars of all foreign related party transactions reported in Parts IV and V of **this** Form 5472. This is the total of the amounts entered on lines 11 and 22 of Part IV plus the fair market value of the nonmonetary and less-than-full consideration transactions reported in Part V. **Do not** complete line 1f if the reportable transaction is with a U.S. related party.

Line 1g. File a separate Form 5472 for each foreign or each U.S. person who is a related party with which the reporting corporation had a reportable transaction. Enter the total number of Forms 5472 (including this one) being filed for the tax year.

Line 1h. Enter the total value in U.S. dollars of all foreign related party transactions reported in Parts IV and V of **all** Forms 5472 filed for the tax year. This is the total of the amounts entered on line 1f of **all** Forms 5472 filed for the tax year (including this one).

Continued on next page

a country(ies) in which business is conducted solely through a subsidiary. **Do not** enter "worldwide" instead of listing the country(ies). These rules also apply to lines 2c, 3c, 4c, Part II, and line 1f, Part III.

Line 2. For purposes of this line:

- "Foreign person" has the same meaning as provided on page 3.
- 50% direct or indirect ownership is determined by applying the constructive ownership rules of section 318 with the modifications listed under *25% foreign shareholder* on page 2.

Part II

Note. *Only 25% foreign-owned U.S. corporations complete Part II.*

The form provides sufficient space to report information for two direct 25% foreign shareholders and two ultimate indirect 25% foreign shareholders. If more space is needed, show the information requested in Part II on an attached sheet.

Report on lines 1a through 1e information about the direct 25% foreign shareholder who owns (by vote or value) the largest percentage of the stock of the U.S. reporting corporation.

Report on lines 2a through 2e information about the direct 25% foreign shareholder who owns (by vote or value) the second-largest percentage of the stock of the U.S. reporting corporation.

Report on lines 3a through 3e information about the ultimate indirect 25% foreign shareholder who owns (by vote or value) the largest percentage of the stock of the U.S. reporting corporation.

Report on lines 4a through 4e information about the ultimate indirect 25% foreign shareholder who owns (by vote or value) the second-largest percentage of the stock of the U.S. reporting corporation.

Lines 3a through 3e and lines 4a through 4e. Attach an explanation of the attribution of ownership. See Rev. Proc. 91-55 and Regulations section 1.6038A-1(e).

Part III

All filers must complete Part III even if the related party has been identified in Part II as a 25% foreign shareholder. Report in Part III information about the related party (domestic or foreign) with which the reporting corporation had reportable transactions during the tax year.

Part IV

Note. ***Do not*** *complete Part IV for transactions with a domestic related party.*

When completing Part IV or Part V, the terms "paid" and "received" include accrued payments and accrued receipts. State all amounts in U.S. dollars and attach a schedule showing the exchange rates used.

that is, in whole or in part, owned by a reporting corporation, the reporting corporation reports only the percentage of the value of the transaction(s) equal to the percentage of its partnership interest. This rule does not apply if the reporting corporation owns a less-than-25% interest in the partnership. The rules of attribution apply when determining the reporting corporation's percentage of partnership interest.

Generally, all reportable transactions between the reporting corporation and a related foreign party must be entered in Part IV.

Reasonable estimates. When actual amounts are not determinable, enter reasonable estimates (see below) of the total dollar amount of each of the categories of transactions conducted between the reporting corporation and the related person in which monetary consideration (U.S. currency or foreign currency) was the sole consideration paid or received during the tax year of the reporting corporation.

A reasonable estimate is any amount reported on Form 5472 that is at least 75% but not more than 125% of the actual amount required to be reported.

Small amounts. If any actual amount in a transaction or a series of transactions between a foreign related party and the reporting corporation does not exceed a total of $50,000, the amount may be reported as "$50,000 or less."

Line 7. Amounts borrowed. Report amounts borrowed using either the outstanding balance method or the monthly average method. If the outstanding balance method is used, enter the beginning and ending outstanding balance for the tax year on lines 7a and 7b. If the monthly average method is used, skip line 7a and enter the monthly average for the tax year on line 7b.

Line 10. Other amounts received. Enter amounts received that are not specifically reported on lines 1 through 9. Include amounts on line 10 to the extent that these amounts are taken into account in determining the taxable income of the reporting corporation.

Line 18. Amounts loaned. Report amounts loaned using either the outstanding balance method or the monthly average method. If the outstanding balance method is used, enter the beginning and ending outstanding balance for the tax year on lines 18a and 18b. If the monthly average method is used, skip line 18a and enter the monthly average for the tax year on line 18b.

Line 21. Other amounts paid. Enter amounts paid that are not specifically reported on lines 12 through 20. Include amounts on line 21 to the extent that these amounts are taken into account in determining the taxable income of the reporting corporation.

Note. *Do not complete Part V for transactions with a domestic related party.*

If the related party is a foreign person, the reporting corporation must attach a schedule describing each reportable transaction, or group of reportable transactions. The description must include sufficient information so that the nature and approximate monetary value of the transaction or group of transactions can be determined. The schedule should include:

1. A description of all property (including monetary consideration), rights, or obligations transferred from the reporting corporation to the foreign related party and from the foreign related party to the reporting corporation;

2. A description of all services performed by the reporting corporation for the foreign related party and by the foreign related party for the reporting corporation; **and**

3. A reasonable estimate of the fair market value of all properties and services exchanged, if possible, or some other reasonable indicator of value.

If the entire consideration received for any transaction includes both tangible and intangible property and the consideration paid is solely monetary consideration, report the transaction in Part IV instead of Part V if the intangible property was related and incidental to the transfer of the tangible property (e.g., a right to warranty services).

See the instructions for Part IV for information on reasonable estimates and small amounts.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	17 hr., 42 min.
Learning about the law or the form	3 hr., 4 min.
Preparing and sending the form to the IRS	3 hr., 30 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

Exhibit 17B – 2, *Form 1120-F*

Form **1120-F**
Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return of a Foreign Corporation

For calendar year 2010, or tax year beginning ______________ , 2010, and ending ____________, 20________

▶ **See separate instructions.**

OMB No. 1545-0126

2010

Type or Print	
	Name
	Number, street, and room or suite no. (see instructions)
	City or town, state and ZIP code, or country (see instructions)

Employer identification number

Check box(es) if:
☐ Initial return
☐ Name or address change
☐ Final return
☐ First post-merger return
☐ Amended return
☐ Schedule M-3 attached
☐ Protective return

A Country of incorporation ______________________

B Foreign country under whose laws the income reported on this return is also subject to tax ______________________

C Date incorporated ______________________

D **(1)** Location of corporation's primary books and records (city, province or state, and country) ______________________

(2) Principal location of worldwide business ______________________

(3) If the corporation maintains an office or place of business in the United States, check here . . . . ▶ ☐

E If the corporation had an agent in the United States at any time during the tax year, enter:

(1) Type of agent ______________________

(2) Name ______________________

(3) Address ______________________

F See the instructions and enter the corporation's principal:

(1) Business activity code number ▶ ______________________

(2) Business activity ▶ ______________________

(3) Product or service ▶ ______________________

G Check method of accounting: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶

		Yes	No
H	Did the corporation's method of accounting change from the preceding tax year? . . . . If "Yes," attach an explanation.		
I	Did the corporation's method of determining income change from the preceding tax year? . . . . . If "Yes," attach an explanation.		
J	Did the corporation file a U.S. income tax return for the preceding tax year?		
K	**(1)** At any time during the tax year, was the corporation engaged in a trade or business in the United States?		
	(2) If "Yes," is taxpayer's trade or business within the United States solely the result of a section 897 (FIRPTA) sale or disposition?		
L	At any time during the tax year, did the corporation have a permanent establishment in the United States for purposes of any applicable tax treaty between the United States and a foreign country? . . . If "Yes," enter the name of the foreign country: ______________		
M	Did the corporation have any transactions with related parties? If "Yes," Form 5472 may have to be filed (see instructions). Enter number of Forms 5472 attached ▶		
	Note: *Additional information is required on page 2.*		

Computation of Tax Due or Overpayment

1	Tax from Section I, line 11, page 2		1		
2	Tax from Section II, Schedule J, line 9, page 4		2		
3	Tax from Section III (add lines 6 and 10 on page 5)		3		
4	**Total tax.** Add lines 1 through 3				4
5a	2009 overpayment credited to 2010 . . .	5a			
b	2010 estimated tax payments	5b			
c	Less 2010 refund applied for on Form 4466	5c ( )			
d	Combine lines 5a through 5c		5d		
e	Tax deposited with Form 7004		5e		
f	Credit for tax paid on undistributed capital gains (attach Form 2439). . . .		5f		
g	Credit for federal tax on fuels (attach Form 4136). See instructions		5g		
h	Refundable credits from Form 3800, line 19c, and Form 8827, line 8c . . .		5h		
i	U.S. income tax paid or withheld at source (add line 12, page 2, and amounts from Forms 8288-A and 8805 (attach Forms 8288-A and 8805))		5i		
j	Total payments. Add lines 5d through 5i				5j
6	Estimated tax penalty (see instructions). Check if Form 2220 is attached . . . . ▶ ☐				6
7	**Amount owed.** If line 5j is smaller than the total of lines 4 and 6, enter amount owed				7
8a	**Overpayment.** If line 5j is larger than the total of lines 4 and 6, enter amount overpaid				8a
b	**Amount of overpayment on line 8a resulting from tax deducted and withheld under Chapter 3** (attach schedule – see instructions)				8b
9	Enter portion of line 8a you want **Credited to 2011 estimated tax** ▶ **Refunded** ▶				9

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer Date ▶ Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ **Yes** ☐ **No**

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11470I Form **1120-F** (2010)

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Exhibit 17B – 3, *Form 1120*

Form 1120 (2010) Page **4**

Schedule K *Continued*

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).		

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) . . . . If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock? . . . . . For rules of attribution, see section 318. If "Yes," enter: **(i)** Percentage owned ► ______ and **(ii)** Owner's country ► ______ **(c)** The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ► ______		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ► ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ► $ ______		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ► ______		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . . . ► ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ► $ ______		
13	Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000? . . . . If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ► $ ______		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)? . . . . . If "Yes," complete and attach Schedule UTP.		

Form **1120** (2010)

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Exhibit 17B – 4, *Letter 3806*

Internal Revenue Service

Department of the Treasury

Taxpayer Identification Number:

Form:

Tax Period(s) Ended:

Date:

Person to Contact:

Contact Telephone Number:

Fax Number:

Employee Identification Number:

Refer Reply to:

Last Date to Respond to this Letter:

CERTIFIED MAIL

Dear

The information available to us indicates that you have not filed a separate annual information return on Form(s) 5472 or that you have filed a substantially incomplete Form(s) 5472 with respect to for the tax period(s) listed above. The information return is required by Internal Revenue Code (IRC) Section 6038A. Treasury Regulation 1.6038A-2 prescribes the information to be included in a complete return.

IRC Section 6038A requires that a penalty of $10,000 be assessed for each taxable year listed above. If you do not file a complete and accurate Form(s) 5472 for more than 90 days after the date of this letter, an additional $10,000 penalty will be imposed for each 30-day period (or fraction thereof) until the form has been filed. The penalty is applicable to each year of failure. There is no limitation on the amount of the monetary penalty that may be assessed.

If you believe that reasonable cause exists for failure to timely furnish this information and that a penalty should not be imposed, you are directed to the provisions of Treasury Regulation 1.6038A-4(b).

Should you want someone to represent you in this matter, please complete Form 2848, *Power of Attorney and Declaration of Representative*, and submit it with your response. The Form 2848 should specify "Form 5472" and "Penalties under Internal Revenue Code Section 6038A" as the "type of tax."

Letter 3806 (11-2003)
Catalog Number 37412C

Continued on next page

You must respond to this letter no later than in order for us to consider your statement prior to the assessment of the initial penalty. Send your completed Form(s) 5472 and/or your statement to the following address:

Internal Revenue Service

If you have any questions, you may contact the person whose name and number appear at the beginning of this letter.

Thank you for your cooperation.

Sincerely yours,

Enclosures:
Publication 1
Notice 609

Letter 3806 (11-2003)
Catalog Number 37412C

International Technical Training

Chapter 18A

Income Taxation of Nongrantor Foreign Trusts

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• Two Hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by instructor) • Flipcharts and markers

Overview

Instructor Notes

This chapter introduces the topic of foreign nongrantor trusts and will discuss the provisions governing them.

Introduction

A foreign trust that is found to be a legitimate separate entity (not a sham, alter ego, etc.) and is not disregarded under the grantor trust rules of IRC §§ 671through 679 is referred to as a “nongrantor foreign trust.”

A nongrantor foreign trust is subject to the same general U.S. tax regime as a nonresident alien individual, with the addition of the special trust provisions of IRC §§ 641through 685. However, the trust and related taxpayers may still be subject to reallocations of income, deductions, or credits.

Objectives

At the end of this lesson, the student will be able to:

- Determine the U.S. income tax liability of a foreign nongrantor trust; and
- Determine the U.S. income tax liability of the beneficiaries of a foreign nongrantor trust.

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Contents

This lesson covers the following topics:

Instructor Notes

May use a PowerPoint presentation to present this chapter.

Definitions

- ☑ **Sourcing of Income:** When the Internal Revenue Code (IRC) speaks of sourcing of income, it is referring to the origin of the income as being earned in the U.S. or in a foreign country.
- ☑ **U.S.-source income:** Income determined by tax law to be from within the United States.
- ☑ **Foreign-source income:** Income determined by tax law to be earned outside the United States.

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United States

United States, when used in a geographical sense, includes 50 states and the District of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive right, in accordance with international law, with respect to the exploration and exploitation of natural resources. It does not include the possessions and territories of the United States or the airspace over the United States **(Treas. Reg. §301.7701(b)-1(c) (2) (ii)).**

Foreign Country

Foreign Country, when used in a geographical sense, includes any territory under the sovereignty of the United Nations or a government other than that of the United States **(Treas. Reg. §301.7701(b)-2(b).**

Nongrantor Foreign Trusts

Reading Assignment

Read IRC §482

Reallocations IRC § 482

IRC § 482 provides that the Service may reallocate items among entities "owned or controlled directly or indirectly by the same interests," where necessary to accurately reflect taxable income. Even if a trust is being disregarded, or treated as a grantor trust, a reallocation may be considered as an alternative position.

Arm's Length Standard

The yardstick for evaluating allocations among related taxpayers is the arm's length standard. Would unrelated parties, acting at arm's length, conduct a transaction on the same terms?

In Haeri, T.C. Memo 1989-20, the Tax Court agreed with the Service that Haeri was the grantor of the Haeri Trust and taxed its investment income to him. However, a second issue involved assignment of Haeri's consulting income to a tax haven corporation. The Court rejected the primary position advanced by the Service (sham corporation) as well as the first alternative position (assignment of income), but upheld the second alternative, IRC § 482 to achieve virtually the same result. This same line of reasoning would apply to transactions with a foreign trust.

Example 18A-1

A taxpayer performs services for a related foreign trust or corporation for significantly less compensation than he or she received in prior years from his or her personal services corporation. It may be appropriate to develop an IRC § 482 adjustment to treat a portion of the trust income as that of the taxpayer.

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Reading Assignment

Read IRC §684

Transfers of Property to Nongrantor Foreign Trusts

When a U.S. person transfers property to a nongrantor foreign trust, the transferor may be required to recognize gain on the transfer. IRC § 684, effective for transfers on or after August 5, 1997, states that such a transfer will be treated as a sale or exchange for an amount equal to the fair market value of the property transferred. The transferor is required to recognize as gain the excess of the property's fair market value over the transferor's adjusted basis. The amount of gain is determined on an asset-by-asset basis.

Under IRC § 684, a U.S. person may not recognize loss on the transfer of an asset to a foreign trust. A U.S. person may not offset gain realized on the transfer of an appreciated asset to a foreign trust by a loss realized on the transfer of a depreciated asset to the foreign trust.

For gift tax purposes, the gift tax annual exclusion of $13,000 (2010 amount) under IRC § 2503(b) is available for the transfer of property to a foreign trust. Separate rules exist for nonresident non-citizen donors of tangible property "situated" in the United States to a foreign trust.

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Transfer of Multiple Treas. Reg. § 1.684 1(d)

Example 18A-2

A (U.S. person) transfers property Q, with a fair market value of 1000X, and property R, with a fair market value of 2000X, to FT (foreign trust). At the time of the transfer, A's adjusted basis in property Q is 700X, and A's adjusted basis in property R is 2200X. FT has no U.S. beneficiary within the meaning of Treas. Reg. § 1.679-2 and no person is treated as owning any portion of FT. Under paragraph (a)(1) of this section, A recognizes the 300X of gain attributable to property Q. A does not recognize the 200X of loss attributable to property R and may not offset that loss against the gain attributable to property Q. IRC § 684 applies only to transfers to nongrantor foreign trusts. Transfers to a trust (or portion of a trust) of which the transferor is treated as the owner under the grantor trust rules are specifically excepted under IRC § 684(b). This provision codifies the interpretation previously articulated in Rev. Rul. 87-61,1987-2 C.B. 219. For as long as the transferor is treated as an owner, the transfer is deemed not to be complete. In such a case, the transferor is not required to recognize gain until he or she ceases to be treated as an owner of the trust (or portion thereof). Such a change may be caused by any of the following events:

- The transferor dies;
- The transferor loses the powers that caused him or her to be treated as an owner;
- If the transferor is treated as an owner under IRC § 679, the trust ceases to have a U.S. person as a beneficiary.

In such a deferred-recognition situation, the gain to be recognized is determined by the fair market value of the property at the time the transfer is deemed complete, reduced by the transferor’s adjusted basis.

Transfers of property to a foreign trust prior to August 5, 1997, were subject to the provisions of former IRC §1491. This section imposed a 35 percent excise tax on the gain unless the taxpayer either elected (before the transfer) to apply principles similar to the principles of IRC § 367 or made an election under former IRC § 1057 to treat the transfer as a taxable exchange. IRC §§ 1491 and 1057 were repealed by the Taxpayer Relief Act of 1997.

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Transfers of Property to Nongrantor Foreign Trusts In Exchange For a Private Annuity

A U.S. person must recognize gain immediately upon the transfer of appreciated property to a foreign trust in exchange for a private annuity. The language of IRC § 684(a) does not provide for any deferral of this gain. Moreover, the legislative history of former IRC § 1491 (the predecessor of IRC § 684 regarding transfers of property by U.S. persons to foreign trusts) makes it clear that Congress did not look favorably upon deferral in the context of transfers to foreign trusts in exchange for private annuities: "The committee believes that any policy in favor of permitting deferral of tax in private annuity transactions should not apply to a private annuity transaction with a foreign trust." S. Rep. No. 94-938, at 217, n.5 (1976).

Exchange Of Property For Private Annuity Treas. Reg § 1-684-1(d)

Example 18A-3

A transfers property that has a fair market value of 1000X to FT in exchange for FT's obligation to pay A 50X per year for the rest of A's life. A's adjusted basis in the property is 100X. FT has no U.S. beneficiary within the meaning of Treas. Reg. § 1.679-2, and no person is treated as owning any portion of FT. A is required to recognize gain equal to 900X immediately upon transfer of the property to the trust. This result applies even though A might otherwise have been allowed to defer recognition of gain under another provision of the Internal Revenue Code.

Change In Trust Situs

IRC § 684(c) also provides that:

- If a U.S. person transfers property to a domestic trust, and such trust becomes a foreign trust, and neither trust is treated as owned by a U.S. person, the trust is treated as having transferred all its assets to a foreign trust immediately before becoming a foreign trust.
- The trust must recognize gain to the extent that the fair market value of its assets exceeds its adjusted basis in those assets.

IRC § 684 final regulations incorporate the relief for inadvertent migrations that is set forth in Treas. Reg. § 301.7701-7(d)(2).

The following examples illustrate the rules of Treas. § Reg.1-684-4 Outbound migrations of domestic trusts:

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Migration of Domestic Trust with U.S. Beneficiaries

Example 18A-4

A (U.S. citizen) transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to T, a domestic trust, for the benefit of A's children who are also U.S. citizens. B (U.S. citizen) is the trustee of T. On January 1, 2001, while A is still alive, B resigns as trustee and C (nonresident alien) becomes successor trustee under the terms of the trust. Pursuant to Treas. Reg. § 301.7701-7(d) of this chapter, T becomes a foreign trust. T has U.S. beneficiaries within the meaning of Treas.
Reg. § 1.679-2 and A is, therefore, treated as owning FT under IRC § 679. Pursuant to Treas. Reg. § 1.684-3(a), neither A nor T is required to recognize gain at the time of the migration. Treas. Reg. § 1.684-2(e) provides rules that may require A to recognize gain upon a subsequent change in the status of the trust.

Migration of Domestic Trust with No U.S. Beneficiaries

Example 18A-5

A (U.S. citizen) transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to T, a domestic trust for the benefit of A's mother who is not a citizen or resident of the United States. T is not treated as owned by another person. B (U.S. citizen) is the trustee of T. On January 1, 2001, while A is still alive, B resigns as trustee and C (nonresident alien) becomes successor trustee under the terms of the trust. The fair market value of the property is still 1000X. Pursuant to Treas.
Reg. § 301.7701-7(d) of this chapter, T becomes a foreign trust, FT. FT has no U.S. beneficiaries within the meaning of Treas.
Reg. § 1.679-2 and no person is treated as owning any portion of FT. T is required to recognize gain of 600X on January 1, 2001.

Taxation of Different Types of Trust Income

Filing Requirement

A nonresident alien fiduciary with income from U.S. sources not covered by withholding is required to file Form 1040NR, U.S. Nonresident Alien Income Tax Return. Form 1040NR is designed to deal with the differing treatments of various classes of income. A check box under the taxpayer identification number (TIN) allows the filer to indicate that the form is being filed for an estate or trust.

The instructions for Form 1040NR contain the following statement:

- If filing Form 1040NR for a nonresident alien estate or trust, change the form to reflect the provisions of Subchapter J, Chapter 1, of the Internal Revenue Code. You may find it helpful to refer to Form 1041, U.S. Income Tax Return for Estate and Trusts and its instructions.
- Forms 1040NR for fiduciaries should state the TIN of the trust. As a result, they are not postable to the IMF, nor are there any provisions for them on the BMF. Non-master file databases are maintained at the Philadelphia Campus (PC).

Categories of Income

When taxable as separate entities, foreign trusts are subject to income tax under a combination of the rules for domestic trusts and nonresident alien individuals. Therefore, their income must be divided into four categories:

- Foreign source income that is not effectively connected with the conduct of a U.S. trade or business,
- Income effectively connected with the conduct of a U.S. trade or business, (which may be either U.S. source or foreign source),
- Other income from U.S. sources, including fixed or determinable annual or periodic income (FDAP) and capital gains, but excluding gains from the sale of U.S. real property interests, and.
- Gains from the sale of U.S. real property interests (FIRPTA).

Foreign Source Income

Income from sources outside the United States is not normally subject to U.S. income tax at the trust level. The exception is income that is “effectively connected” with the conduct of a trade or business within the United States (sometimes referred to as “ECI”).

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Effectively Connected Income (ECI)

No trust should normally be engaged in a continuing trade or business in the U.S. (Treas. Reg. § 301.7701-4). However, a foreign trust may be involved in the “winding up” of an estate for some period of time. Also, a foreign trust that holds an interest in a partnership that is engaged in a U.S. trade or business will itself be deemed to be engaged in such trade or business. Other exceptions would be oil and gas working interests and elective treatment of real property operations as a trade or business.

To avoid giving foreign trusts engaged in business activities a competitive advantage (see preceding paragraph), income from such activities is taxed in a manner similar to domestic businesses. Such income is taxed at the graduated rates applied to that of domestic trusts by IRC § 1(e) (currently, a top rate of 39.6 percent on taxable income over $7,500). Taxable income is computed using the same trade or business deductions allowed a corporate or individual taxpayer. However, trusts that currently distribute their income to beneficiaries are allowed the deduction for the distribution under IRC § 651.

Reading Assignment

Read IRC §871

FDAP – Fixed or Determinable, Annual or Periodic Income

IRC § 871(a) imposes a flat tax of 30 percent on “fixed or determinable, annual, or periodic income (FDAP) from sources within the United States. FDAP generally includes interest, dividends, rents, royalties, and similar payments. However, IRC § 871(h) (the “portfolio interest” exception) specifically excludes interest on bank deposits from the definition of FDAP income subject to tax.

No deductions for related expenses are allowed in computing FDAP income subject to tax.

Effect of Tax Treaties

The tax on FDAP income may be reduced or eliminated under income tax treaties between the United States and a number of other countries.

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Withholding Of Tax on FDAP

The tax under IRC § 871(a) is intended to be collected primarily through withholding by the U.S. person making payment to the foreign person. IRC § 1441 contains the withholding requirement and the regulations require that the withholding agent withhold and pay tax at 30 percent withholding rate, unless the payee provides specific documents to claim treaty benefits or trade or business connection of the income (FormW-8BEN, Form W-8IMY, Form W-8EXP, Form W-8ECI and Form 8233).

Treaty Shopping

Many income tax treaties incorporate “anti-treaty shopping” provisions. The entity desiring treaty benefits may not be entitled to them if it is organized in the treaty country solely for the purpose of obtaining such benefits.

Capital Gains

Capital gains realized by a nongrantor trust from U.S. sources are not taxable by the U.S., unless they fall under one of the following exceptions. (Remember that the foreign nongrantor trust is taxed in the same manner as a nonresident alien individual.)

- IRC § 871(b) subjects gains effectively connected with the conduct of a U.S. trade or business to the same taxation as if the taxpayer were a U.S. citizen or resident, with reference to IRC §§ 1 and 55 (and through December 31, 1999, to IRS § 402(d)(1)).
- IRC § 871(a)(2) imposes a 30 percent tax on capital gains if the trust was “present” in the United States for 183 days or more during the taxable year. In practice, this refers to the presence of the trustee. However, the Service has taken the position that a simple trust will not be taxed on its capital gains simply because of the trustee’s presence, if the income is currently distributed to the beneficiaries (Rev. Rul. 68-621, 1968-2 C.B. 286; PLR 7933075).
- IRC § 897 states that gains from the sale of a “U.S. real property interest” are to be treated as effectively connected income taxed by IRC § 871(b).

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U.S. Real Property Interests (USRPI)

IRC § 897(c) defines a "United States real property interest" (USRPI) to include:

- Direct ownership of real property located in the United States, including buildings and fixtures.
- A partner's or beneficiary's pro rata share of USRPI owned by a partnership or trust.
- Any interest, other than as a creditor, in a "United States real property holding corporation" (USRPHC). A USRPHC is a corporation, the majority of whose business assets consist of USRPIs, excluding corporations whose stock is regularly traded on established securities markets. Stock in a corporation may retain its "taint" as a USRPHC for five years after ceasing to be one; see IRC § 897 for details.

Income from U.S. Real Property Interests

Rents and royalties are normally defined as FDAP income and are subject to tax at the fixed 30 percent rate (unless reduced or eliminated by treaty), without any deductions. IRC § 871(d) permits a nonresident alien individual (including a trust) to elect to treat all its passive income from U.S. real property interests as effectively connected with a U.S. trade or business. This results in taxation at the graduated rates. More importantly, it allows the taxpayer to take depreciation, interest, and operating expense deductions not otherwise allowable.

The election under IRC § 871(d) once made, can only be revoked with prior IRS approval.

Rev. Rul. 73-522, 1973-2 C.B.226, defines passive U.S. real estate operations.

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Dispositions of USRPI

- Net gains from disposition of USRPI are taxed under IRC § 897(a)(2) at a rate of 26 percent of the amount up to $175,000 plus 28 percent of the amount that exceeds $175,000 (these rates are from IRC § 55(b)(1)(A) – Alternative Minimum Tax) for nonresident alien individuals.
- Although IRC § 897 refers only to nonresident alien individuals and foreign corporations, USRPI's owned by a trust are attributed to the person(s) treated as the owner(s) of grantor trusts and to the beneficiaries of nongrantor trusts. The owner's or beneficiary's percentage ownership of a USRPI is based on his or her percentage ownership in the trust.

Expenses of Property Not Placed In Service

Rev. Rul. 91-7, 1991-1 C.B. 110, holds that a foreign corporation may not make the election under IRC § 882(d) when the taxpayer does not derive income from the property. Furthermore, the ruling also holds that the taxpayer may not elect to capitalize the expenses that otherwise would not be deductible. Because IRC § 882 is the corporate parallel to IRC § 871, the same reasoning should apply to a foreign trust. Therefore, expenses incurred in connection with a USRPI prior to placing the property in service cannot be deducted, nor can they be capitalized and included in the basis on sale or disposition.

Withholding On Dispositions of USRPI's

IRC § 1445 requires the transferee (purchaser) of a USRPI from a foreign person, including a trust to withhold tax at the rate of 10 percent of the "amount realized" on the sale. The amount realized includes cash, other property, and any debt of which the transferor is relieved. The code provides for certain exemptions, primary among which is property with a sale price of less than $300,000 to be used as the transferee's residence.

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USRPI's Held Through Domestic Partnerships Or Trusts

IRC § 1445 also requires that domestic partnerships, trusts, and estates account for the gains and losses of any foreign partner or beneficiary on sales or other dispositions of USRPIs.

The partnership, trustee, or executor is required to withhold tax at the rate of 35 percent on any distribution to a foreign partner or beneficiary from the USRPI account. The foreign partner or beneficiary is taxed on the gain under IRC § 897.
See Treas. Reg. § 1.1445-5(c)(1)(iii).

Computing The Taxable Income Effectively Connected With A U.S. Trade Or Business

The U.S. trade or business income of a foreign trust is computed using only the items of income and expense directly from, or effectively connected with, such trade or business, and the allocable portion of other expenses, in proportion to the ratio of U.S. income to worldwide income (see IRC §§ 861through 865 for rules on allocation and apportionment of expenses).

If a foreign trust has income from both U.S. and foreign sources, only a pro rata portion of trust administration expenses will be allowed in computing U.S. taxable income.

The computation of taxable income for a trust is similar to that for an individual, with the exception of the income distribution deduction for trusts, types of itemized deductions, and the exemption amount.

Income Distribution Deduction

The foreign trust is allowed the income distribution deduction under IRC § 651 (simple trusts) or IRC § 661 (complex trusts). The trust itself is taxed on undistributed income, while the distributable income is treated as distributed to the beneficiaries, whether or not it is actually distributed.

For simple trusts, the deduction is the amount of income required to be distributed, limited to the trust's distributable net income (DNI) for the year.

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Income Distribution Deduction (continued)

For complex trusts, the deduction is the sum of:

- The amount of income required to be distributed currently, plus
- Any other amounts properly paid or credited from income for the year; however, the total deduction is limited to the amount of DNI.

However, for purposes of computing the income distribution deduction of a simple or complex trust, exempt income and related expenses must be excluded. Computation of the trust's DNI is discussed below.

In the case of a trust having more than one class of income from U.S. sources (for example., both ECI and FDAP income), the income distribution deduction is to be allocated in proportion to gross income of the classes in order to arrive at taxable income under each tax regime.

Abuse of the Income Distribution Deduction

The income distribution deduction is a central feature of many abusive trust schemes. The perpetrators may file income tax returns for one or more "tiers" of foreign trusts that, in turn, distribute most or all of their net income to another trust. At some point in the chain, the scheme rationalizes that the income is no longer from a U.S. source, and no longer taxable by the U.S.

It is important to remember that for any trust treated as a grantor trust under IRC §§ 671 through 679, or otherwise disregarded as a separate entity for income tax purposes, the income distribution deduction is not allowed in computing the income taxable to the grantor or other person to whom the income is attributed. IRC §§ 651 and 661 allow the deduction only for trusts that are treated as such for income tax purposes.

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Distributable Net Income (DNI)

Besides limiting the income distribution deduction of the trust, DNI also determines the amount of distributions on which a beneficiary will be taxed. In the event the trust is required to distribute an amount in excess of DNI, the beneficiaries are taxed only on their respective shares of DNI.

The distributable net income of a foreign trust is computed in much the same way as that of a domestic trust, the primary exception being that all capital gains are included, regardless of how they are regarded by the trust instrument or local law. Therefore, if DNI includes capital gains, each beneficiary's share of DNI will carry with it a ratable portion of those gains, which retain their character as such. A beneficiary's share of DNI may include ordinary income, short-term, and long-term capital gains. Each category of income must be treated as such on the beneficiary's U.S. income tax return.

Another key point is that DNI is computed without regard to any treaty exemptions.

Alternative Minimum Tax

Like domestic nongrantor trusts, foreign nongrantor trusts are subject to the alternative minimum tax (AMT) under IRC § 55, but only with respect to income, deductions, preferences, etc., from U.S. sources.

U.S. Beneficiaries of Foreign Trusts

Beneficiaries Of Nongrantor Trusts

U.S. persons are taxed on their worldwide income, according to IRC § 61. In general, a resident alien is either a lawful permanent resident (holds a "green card") or someone who meets the substantial presence tests set forth in IRC § 7701(b)(3).

If a foreign trust is not treated as a grantor trust, distributions of its income to U.S. beneficiaries are generally taxed in the same manner as distributions from a nongrantor domestic trust. Each beneficiary must include in income his or her share of the distributable net income (DNI) of the trust.

A net operating loss of a trust cannot be distributed to the beneficiaries; however, IRC § 642(h) provides that the cumulative net operating loss becomes available to the beneficiaries when the trust terminates.

Distributions of trust corpus are not taxable. In some cases, the key issue is often the determination of how much, if any, of a distribution consists of income as opposed to corpus.

Accumulation Distributions

A complex trust may accumulate income from one year to the next instead of distributing it.

When income accumulated from prior years is distributed, a U.S. beneficiary of a nongrantor foreign trust may be required to calculate additional taxes under IRC §§ 666 through 668.

In general, income included in an accumulation distribution retains its character. A key exception is that capital gains lose their distinction as such, and are taxed as ordinary income.

Throwback Tax On Accumulation Distributions

When a complex trust distributes income accumulated in prior years, IRC § 667 imposes a "throwback" tax designed to approximate the tax that would have been paid by the beneficiary had the income been spread over the accumulation years.

This tax is effective for each year of accumulation beginning after December 31, 1976, and applies to foreign trusts, domestic trusts that were once treated as foreign trusts and to trusts created before March 1, 1984, that would be treated as multiple trusts under IRC § 643(f).

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Exception For Specific Distributions

One exception to the rules for accumulation distributions is very important. A distribution is not considered an accumulation distribution if it does not carry out distributable net income (DNI). IRC § 663(a) excludes from the definition of an accumulation distribution a “gift or bequest” of a specific sum of money or specific property to the extent it is not paid from the income of the trust.

Therefore, a trust may accumulate income, while making such specific distributions and escape the additional tax on accumulation distributions.

Reading Assignment

Read IRC §667

Computing the Throwback Tax

The computation of the throwback tax on accumulation distributions involves five steps:

Step	Action
1	Determine the number of years to which the distribution is to be attributed. This will normally be the earliest years in which the trust had undistributed net income (UNI).
2	Determine the “average years” or “base years.” These are: • Three of the five immediately preceding taxable years of the beneficiary, • Excluding the years with the highest and lowest total taxable income.
3	Determine the average annual accumulation by dividing the total accumulation distribution (including the amount of any taxes paid by the trust on the distribution) by the number of years in which it was accumulated. Add this average annual accumulation to the greater of: • (a) The beneficiary’s taxable income, or • (b) Zero, for each of the average years.

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Computing the Throwback Tax (continued)

Step	Action
4	Compute the increase in the beneficiary's tax for each of the base years, and then average by dividing by the number of base years.
5	Compute the "partial tax" on the accumulation distribution by • Multiplying the annual average determined in step 4 • By the number of years of income accumulation, and • Subtracting the credit for taxes paid by the trust on the distribution.

Interest Charge On Accumulation Distributions Of Foreign Trusts

In addition to the "throwback" tax, IRC § 668 imposes an additional interest charge on the partial tax computed under IRC § 667(b).

Accumulation distributions from foreign trusts also are subject to an additional tax that amounts to an interest charge. IRC § 668 imposes an interest charge on the beneficiary's tax on an accumulation distribution from a foreign trust for each year of accumulation beginning after December 31, 1976.

For accumulation distributions in 1996 and later years, simple interest is accrued at the rate of six percent through 1995. Beginning on January 1, 1996, compound interest is imposed not only on tax amounts determined under the accumulation distribution rules, but also on the total simple interest for pre-1996 periods, if any, under the same rules of IRC § 6621 that apply to an underpayment of tax.

For purposes of computing the interest charge, the accumulation distribution is allocated proportionately to prior trust years in which the trust has undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution is treated as reducing proportionately the undistributed net income from prior years.

The interest charge under IRC § 668 is in addition to any other tax for which the beneficiary may be liable with respect to a distribution from a nongrantor foreign trust.

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Timing Of Distributions

A fiduciary may make an election to treat distributions made in the first 65 days of a taxable year as having been made on the last day of the prior year, eliminating one year from the computation.
Treas. Reg. § 1.663(b)-1.

Foreign Tax Credits

The beneficiary is entitled to a credit for any taxes the trust paid on the accumulated income when it was earned. The taxpayer will have to produce adequate documentation to show that the taxes claimed were, in fact, paid by the trust; that the taxes are creditable taxes under IRC § 901; and the taxpayer must properly compute the limitation under IRC § 902 for each income “basket” that applies.

Change In Trust Status

A nongrantor foreign trust, to which a U.S transferor has transferred property, that subsequently acquires a U.S. beneficiary may therefore become a grantor trust by operation of IRC § 679. In such a case, any accumulated trust income is treated as an immediate accumulation distribution to the person treated as the owner.
Treas Reg § 1.679 2(c)(1).

If the U.S. beneficiaries does not draw distributions to which they are entitled, but instead allows the funds to remain in trust and accumulate income, that beneficiary is treated as an owner of the trust under IRC § 679, but only with respect to that portion of the trust assets “transferred” by the beneficiary.
See Treas. Reg. § 1.679-2(c)(3), Example 1.

Foreign Trust Which Becomes A U.S. Trust

If a foreign trust with accumulated income becomes a U.S. trust, any subsequent distribution of income deemed to have been made in a year it was a foreign trust is treated as an accumulation distribution from a foreign trust. Any such distribution should be subject to the interest charge rules of IRC § 668. (Rev. Rul. 91-6, 1991-1 C.B.89)

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Reporting The Additional Tax And Interest Charges

For 1996 and prior years, the additional tax under IRC § 667 was computed and reported on Form 4970, Tax on Accumulation Distribution of Trusts.

Beginning with tax year 1997, both the “throwback” tax and the interest charge are to be reported on Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Form 4970 may be required as an attachment to Form 3520.

The calculated amount is to be included on the beneficiary’s income tax return.

The Hiring Incentive to Restore Employment (HIRE) Act passed in 2010 now requires the completion of Part II of Form 3520 even if there have been no transactions involving the trust during the year.

The HIRE Act also amended IRC § 6677(a)(2) to include a $10,000 penalty for failure to file Form 3520. The penalty is no the greater of $10,000 or (1) 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust, or (2) 35% of the gross value of the distribution received from a foreign trust for failure by a U.S. person to report receipt of the distribution, or (3) 5% of the gross value of the portion of the trust’s assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

Distributions Through Nominees IR § 643(h)

Taxpayers may attempt to avoid the additional tax and interest charges by causing a foreign trust to make a distribution to a U.S. person through a nominee or intermediary.

IRC § 643(h), which was enacted as part of the Small Business Job Protection Act of 1996, addresses this potential abuse. Under IRC § 643(h), any amount paid to a U.S. person that is derived (directly or indirectly) from a foreign trust of which the payor is not the grantor will be deemed in the year of payment to have been directly paid by the foreign trust to the U.S. person, with the result that additional tax and interest charges cannot be avoided.

Final regulations implementing IRC § 643(h) were issued on August 10, 1999 (TD 8831).

U.S. Persons Who Expatriate to Avoid Tax

Who is an Expatriate?

The term “expatriate” is often used in other contexts to refer to any U.S. citizen who chooses to live abroad. IRC § 877 specifically applies to persons who give up their U.S. citizenship before June 17, 2008 with tax avoidance as one of their “principal purposes.”

This Code section applies to any nonresident alien individual who, within the ten-year period immediately proceeding the taxable year, lost U.S. citizenship, unless such loss did not have avoidance of U.S. taxes as one of its principal purposes.

Persons Presumed to Have a Tax Avoidance Purpose

Individuals are presumed to have a tax avoidance purpose if they had an average annual net income (as defined in IRC § 38(c)(1)) over $145,000 (2010 amount as indeed for inflation) for a five-year period preceding the year of loss of citizenship, or a net worth of $2,000,000 or more on the date of loss of citizenship, except for:

- Certain cases of dual citizenship.
- Persons who have been present in the United States for 30 days or less in each year of the ten year period preceding the date of loss of citizenship.
- Individuals who renounce their U.S. citizenship upon reaching the age of majority, and prior to attaining the age of 18 ½.
- Individuals who have requested a ruling by the Secretary within one year after loss of citizenship and have received a favorable ruling or a ruling that they have fully submitted all of the information necessary to obtain a ruling.

Reading Assignment

Read IRC §§877 and 877A

Continued on next page

Taxation of Expatriates' Income

Expatriates, before June 17, 2008, treated as having a tax avoidance purpose are subject to the rules under which nonresident aliens are normally taxed, with certain modifications in IRC § 877(a), including the following:

- An alternative tax is imposed under IRC § 877(b).
- Gains on sales of U.S. property are treated as taxable income from the United States.
- Gains on sales of stock issued by a U.S. corporation or debt obligations of U.S. persons are treated as taxable income from the United States.
- Capital loss carryovers are not allowed.

Expatriates after June 16, 2008 are subject to a mark-to-market tax regime under which they are taxed on the unreagized gain in their property to the extent it exceeds $627,000 (2010 amount as indexed) under new IRC §877A.

If the individual is a beneficiary of a nongrantor trust on the day before the individual's expatriation date, and receives a direct or indirect distribution of any property from the trust, then the trustee must deduct and withhold 30% of the taxable portion of the distribution.
(IRC §877A(f)

Additionally, if the fair market value of the property distributed exceeds the adjusted basis in the hands of the trust, the trust must recognize gain as if the property was sold to the expatriate at its fair market value.

Character of Trust Income in Hands of Beneficiaries

In General

If a foreign trust is not treated as a grantor trust, distributions of its income are taxable to U.S. beneficiaries when made. Distributions of trust corpus are not taxable. IRC § 652 (simple trusts) and IRC § 661 (complex trusts) specify that distributions have the same character in the hands of the beneficiaries that the income had in the hands of the trustee.

Passive Vs. Nonpassive Income

The passive activity loss (PAL) limitations of IRC § 469 are applied first at the trust level.

Rental activities are defined as passive activities by IRC § 469(c)(2). Losses from such activities may be deducted by the trust only against passive income.

It is particularly important to note that a trust is not allowed the $25,000 offset of PAL's from rental real estate against nonpassive income provided in IRC § 469(i). IRC § 469(i)(1) provides that this allowance may only be used by "natural persons." Since a nongrantor trust is treated as an entirely separate entity, no such offset is allowed.

Passive losses can be used only to offset passive income. Passive income can arise from only two sources:

- Rental activities, and
- Business activities without material participation.

The determination as to whether a nonrental activity is passive or nonpassive is based on the participation of the trustee. The trustee must materially participate in the activity on a regular, continuous, and substantial basis. When an activity is claimed to be nonpassive, you should carefully consider whether it is likely that the trustee met this requirement.

Disallowed passive losses are suspended at the trust level, and must be carried forward.

They cannot be used by the beneficiaries, and they cannot be used to offset portfolio income.

Continued on next page

Passive Vs. Nonpassive Income (continued)

Income distributable to the beneficiaries retains its character as passive, portfolio, etc., in the hands of the beneficiaries. The beneficiaries must consider this in computing their own PAL limitations.

If a trust distributes a passive activity (for example, a rental property or a partnership interest) to a beneficiary, the distribution is treated as a distribution of corpus. The recipient's basis is increased by the amount of current and suspended losses (IRC § 469(j)(12)).

If a passive activity is sold to the beneficiary or another related party, losses are prohibited by IRC §§ 267(b) and 469(g).

Suspended losses may be used only when the activity is disposed of in a fully taxable transaction to an unrelated party.

Foreign Beneficiaries of Foreign Trusts

Beneficiaries of Nongrantor Trusts

If a foreign trust is not treated as a grantor trust, foreign beneficiaries may be subject to U.S. tax on distributions of trust income arising from U.S. sources. This is because the trust itself is allowed to use the income distribution deduction. The foreign beneficiary is taxed on the lesser of their share of U.S. sourced DNI or the amount actually received. The foreign beneficiary is generally required to file Form 1040NR.

Distributions of FDAP income are subject to U.S. withholding tax under IRC §§ 1441 and 1442. The trustee is the withholding agent. If the foreign beneficiary has only income subject to withholding, and his or her U.S. tax liability is entirely satisfied by withholding, no Form 1040NR need be filed.

Beneficiaries Of Grantor Trusts

The income of a grantor trust is taxed to the person treated as the owner, foreign beneficiaries of grantor trusts receive income distributions free of U.S. income tax.

Loans to Grantors or Beneficiaries

Loans From A Foreign Trust

Prior to 1996, loans from foreign trusts were sometimes used as a way to make the assets of a foreign trust available tax free to U.S. grantors, beneficiaries, or related parties.

IRC § 643(i), enacted in 1996 provides that except as defined by regulations, any loan of cash or marketable securities by a foreign trust to a U.S. grantor or beneficiary (or any U.S. person related to a grantor or beneficiary) will be treated as a distribution to the grantor or beneficiary. This provision applies to loans made after September 19, 1995.

Summary

Summary The following table summarizes the taxation of foreign trusts.

	Fixed or Determinable, Annual or Periodic Income (FDAP)	Income Effectively Connected With a U.S. Trade or Business (ECI)	Gains From Sale of U.S. Real Property Interests	Other Capital Gains (Not-real estate; not ECI)	Foreign Source Income
Nongrantor Trust (or Portion of Trust)	*Taxed at flat rate of 30%, unless reduced or exempted by treaty.*	Taxed at graduated trust rates.	Taxed at graduated individual rates.	Not taxable by the United States.	Not taxable by the United States, unless ECI.
Trust (or Portion of Trust) With U.S. Persons Treated As Owners	Trust is disregarded for U.S. income tax purposes. All income is taxed under the usual domestic rules to the person(s) treated as the owner(s). If Foreign Trust does not provide a Form W-9, there may be a 30 percent withholding for FDAP.				
Trust (or Portion of Trust) With Foreign Person Treated As Owner	Trust is disregarded. Income is taxed at flat rate of 30%, unless reduced or exempted by treaty.	Trust is disregarded. Income is taxed at graduated individual rates.	Trust is disregarded. Income is taxed at graduated individual rates.	Trust is disregarded. Income is not taxable by the United States.	Trust is disregarded. Income is not taxable by the United States, unless ECI

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International Technical Training

Chapter 18B

Income Taxation of Foreign Grantor Trusts

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• Two Hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk
Participant References	• None
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by instructor) • Flipcharts and markers

Overview

Instructor Notes

This chapter introduces the topic of foreign grantor trusts and will discuss the provisions governing them.

Introduction

Although a foreign trust may be respected as a separate legal entity under foreign law, it may not be respected as such under U.S. law and its income may still be attributed to one or more persons treated as owners under the “grantor trust rules” of IRC §§ 671-679.

IRC § 679 is specifically designed to prevent U.S. taxpayers from achieving tax deferral by transferring property to foreign trusts.

A taxpayer treated as an owner of a trust is required to report his or her share of trust income, deductions, and credits as if those items were received or paid directly by the taxpayer.

Objectives

At the end of this lesson, the student will be able to:

- Identify a grantor trust under the general rules of IRC §§ 671-678,
- Determine whether a foreign trust is a grantor trust by operation of IRC § 679, and
- Describe the proper tax treatment of the income of a grantor trust.

Continued on next page

Contents

This lesson covers the following topics:

Instructor Notes

May use a PowerPoint presentation to present this chapter.

Continued on next page

Definitions

- ☑ **<u>Sourcing of Income</u>**: When the Internal Revenue Code (IRC) speaks of sourcing of income, it is referring to the origin of the income as being earned in the U.S. or in a foreign country.
- ☑ **<u>U.S.-source income</u>**: income determined by tax law to be from within the United States.
- ☑ **<u>Foreign-source income</u>**: income determined by tax law to be earned outside the United States.

United States

United States, when used in a geographical sense, includes 50 states and the District of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive right, in accordance with international law, with respect to the exploration and exploitation of natural resources. It does not include the possessions and territories of the United States or the airspace over the United States **(Treas. Reg. §301.7701(b)-1(c) (2) (ii))**.

Foreign Country

Foreign Country, when used in a geographical sense, includes any territory under the sovereignty of the United Nations or a government other than that of the United States **(Treas. Reg. §301.7701(b)-2(b))**.

What is a "Grantor Trust?"

Introduction

Key Points:

- The term "Grantor" is generally used to refer to anyone who transfers property to a trust. The term "Grantor Trust" has a special, and somewhat different, meaning in the context of the Internal Revenue Code.
- The "grantor trust rules" of IRC §§ 671-679 may operate to treat the grantor or another person as owner of all or a portion of a trust. These rules were originally designed to prevent a person from reducing a family's total tax bill by shifting income-producing property to a trust in a lower income tax bracket than the person's own tax bracket. The grantor trust rules are based upon the idea that a trust should not be recognized as a separate taxable entity if some person has such dominion and control over it as to create an identity of interest between that person and the trust. This concept was originally developed by the courts in a series of judicial decisions and was eventually codified by Congress.
- If a trust is characterized as a grantor trust under IRC §§ 673-677 or IRC § 679, the trust is ignored for income tax purposes and the grantor is treated as owner of the trust assets. Pursuant to IRC § 678, a person other than a grantor of a trust may be treated as an owner of a trust if the person holds certain powers with respect to the trust. In general, any person treated as the owner of the trust under these rules is taxed directly on the income earned by the property that has been placed in the trust.

Continued on next page

Reading Assignment

Read IRC §671

The Grantor Trust Rules

Under IRC §671, a trust that is a legal entity for other purposes may not be recognized for federal income tax purposes because a grantor or other substantial owner has retained certain powers over, or interests in, the income or corpus of the trust. The specified powers are enumerated in IRC §§ 673-678:

IRC § 673 – Reversionary interests.
IRC § 674 – Power to control beneficial enjoyment.
IRC § 675 – Administrative powers.
IRC § 676 – Power to revoke.
IRC § 677 – Income for benefit of grantor.
IRC § 678 – Person other than grantor treated as owner.

Each rule is subject to certain exceptions as set forth in the appropriate code section.

The term “grantor” refers specifically to anyone who creates a trust or gratuitously transfers property to a trust (Treas. Reg. §1.671-2 (e)). A “power” held by a grantor or nonadverse party is considered **a grantor power** if it is exercisable without the approval of an adverse party. It does not matter whether the trust is a foreign trust or a domestic trust. However, if a grantor is not a U.S. person, IRC § 672 (f) limits the circumstances under which the trust is treated as owned by the grantor.

Also, under the rules of IRC § 679, a U.S. person who transfers property to a foreign trust that has a U.S. beneficiary may be treated as an owner of the portion of the trust attributable to such property without regard to whether he or she has any powers enumerated in IRC §§ 673-677. In other words, IRC § 679 supersedes the other grantor trust rules with respect to any portion a trust to which it applies.

Continued on next page

Reading Assignment

Read IRC §673

Reversionary Interests IRC § 673

Key Point:

- A grantor will be treated as an owner of any portion of a trust in which he/she has a reversionary interest in either income or corpus, if the value of such interest exceeds five percent of the value of such portion as of the inception of the trust. There is an exception for reversionary interests that take effect only at the death of a minor lineal descendant.

Reading Assignment

Read IRC §674

Power to Control Beneficial Enjoyment IRC § 674

A grantor will be treated as an owner of any portion of a trust of which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable without the approval or consent of an adverse party. There are certain exceptions, including the following:

- A power to apply income in support of a dependent, as described in IRC § 677(b), to the extent that the grantor would not be subject to tax under that section.
- A power whose exercise can affect the beneficial enjoyment of income only after the occurrence of some event, such that the grantor is treated as the owner only after the event, unless the power is relinquished.
- A power exercisable only by will, except for a power to appoint by will income of the trust that is accumulated for such disposition by the grantor, or may be so accumulated in the discretion of the grantor or a nonadverse party, without the approval or consent of an adverse party.

Continued on next page

Reading Assignment

Read IRC § 675.

Administrative Powers IRC § 675

A grantor will be treated as the owner of any portion of a trust in respect of which:

- The grantor or a nonadverse party has the power to sell, exchange, or deal with or dispose of trust income or corpus to the grantor or any other party for less than adequate consideration,
- The grantor or a nonadverse party has the power to borrow trust corpus or income without adequate interest or security, except where the trustee has a general lending power to make loans to any person without regard to interest or security,
- The grantor has directly or indirectly borrowed corpus or income and has not completely repaid the loan before the beginning of the taxable year, except for loans made with adequate interest and security made by a trustee other than the grantor and not related or subservient to the grantor (for this purpose, "grantor" refers to the grantor's spouse, as well), or
- Any power of administration is exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, including any of the following powers:
    - To vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control,
    - To control the investment of trust funds by directing or vetoing investments or reinvestments, to the extent that trust funds consist of securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control, or
    - To reacquire the trust corpus by substituting property of an equivalent value.

Continued on next page

Reading Assignment

Read IRC §676.

Power to Revoke IRC § 676

A grantor will be treated as an owner of any portion of a trust over which the grantor (or any nonadverse party) has a power to revoke the trust.

Reading Assignment

Read IRC §677

Income for Benefit of Grantor IRC § 677

A grantor will be treated as the owner of any portion of a trust if the income from which it derives, without approval or consent of an adverse party or in the discretion of the grantor or a nonadverse party, is distributed to the grantor or the grantor's spouse, accumulated for future distribution to the grantor or the grantor's spouse, or applied to payment of premiums on insurance policies on the life of the grantor or the grantor's spouse.

Continued on next page

Reading Assignment

Read IRC §678.

Person Other Than Grantor Treated As Owner IRC § 678

A person other than a grantor may be treated as an owner of any portion of a trust with respect to which:

- He or she has sole power to vest the corpus or income in himself or herself, or
- He or she has released or modified such power, but retained such control as would cause a grantor to be treated as the owner of the trust under IRC §§ 671-677.

This section applies only to portions of the trust of which the grantor or transferor is not already deemed to be an owner under IRC §§ 671-677 and 679.

Exercise 18B – 1

Mary, a native of Texas, was concerned about her only son's spendthrift ways. Mary wanted to ensure that her granddaughter, then aged 17, received a good college education. Mary established an irrevocable trust for her granddaughter and funded the trust with a cash gift of $150,000. The trustee is a bank in Texas.

Under the terms of the trust agreement, the trustee is to make distributions of income and corpus for the support and education of the beneficiary, but only during such time as the beneficiary is enrolled as a full-time student in an accredited college. The trust will terminate when the beneficiary attains age 25. If the beneficiary has completed at least four years' credit in an accredited college, any remaining assets will be distributed to the beneficiary. Otherwise, any remaining assets will be transferred back to Mary or, if she is deceased, to the Mary Community Charity Foundation.

Continued on next page

Exercise 18B-1

Is Mary treated as the owner of this trust?

Answer:

Exercise 18B-2

Nancy, a naturalized U.S. citizen, transferred stock valued at $2.3 million to a trust organized in Gibraltar. The trust is for the benefit of Nancy's mother Bonnie, who is a citizen and resident of the United Kingdom. The trust is irrevocable, and in the event of Bonnie's death any corpus and income remaining in the trust will be distributed to Bonnie's church in Bedfordshire.

Exercise 18B-2

Is Nancy treated as the owner of this trust?

Answer:

Would your answer differ if, on Bonnie's death, any remaining corpus and income reverted to Nancy?

Answer:

What if it reverted to Nancy's children?

Answer:

Continued on next page

Exercise 18B-3

Linda is the sole beneficiary of a trust created by her grandmother. The initial trustee was Cecilia, a trusted friend of Linda's grandmother. Linda, as trust protector, had the right to appoint a successor trustee, and on Cecilia's death in 1993, she appointed herself trustee.

Exercise 18B-3

Is Linda treated as an owner of the trust under the grantor trust rules?

Answer:

Special Rule for Foreign Trusts with U.S. Beneficiaries

IRC § 679

In 1976, IRC § 679 was added to the Code, extending grantor trust treatment to certain foreign trusts regardless of whether the grantor or any other person (United States or foreign) holds any of the powers set forth in IRC §§ 671-678. IRC § 679 treats as an owner any U.S. person who transfers property to a foreign trust that has one or more U.S. beneficiaries.

Reading Assignment

Read IRC §679.

Law Prior To IRC § 679

Prior to the enactment of IRC § 679, if a trust was not subject to the grantor trust rules (nongrantor trust), the income of the domestic or foreign trust generally was taxed to the trust to the extent the income was not currently distributed or required to be distributed to the beneficiaries of the trust.

The income of a foreign nongrantor trust is taxed in basically the same manner as the income of a nonresident alien individual:

- withholding tax on its U.S. sourced non-business income (FDAP), and
- taxed at a graduated rate on any effectively connected income (ECI) with a U.S. trade or business.

Like nonresident alien individuals, foreign nongrantor trusts are generally not subject to U.S. tax on foreign sourced income.

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Foreign Trusts Accumulated Income Free Of Any Tax

Prior to the enactment of IRC § 679, U.S. persons often established foreign nongrantor trusts that invested in assets that generated foreign sourced income only.

These foreign nongrantor trusts avoided all U.S. tax on their income by investing in countries that did not tax interest or dividends paid to foreign investors. In many cases the trusts paid no income tax anywhere in the world.

The U.S. beneficiaries were subject to U.S. tax when a foreign nongrantor trust distributed income to them. However, the use of foreign nongrantor trusts permitted tax free accumulations of income giving foreign trusts a significant advantage over domestic trusts.

Foreign Trusts Had Advantage over Domestic Trusts

Congress believed that allowing tax-free accumulation of income was inappropriate and provided an unwarranted advantage to foreign trusts over domestic trusts.

Congress enacted IRC § 679 in 1976 Act to provide generally that where a U.S. person directly or indirectly transfers property to a foreign trust, the income of the foreign trust is taxable to the transferor if the trust has a U.S. beneficiary. Accordingly, the trust is treated as a grantor trust whether or not the transferor retains any power or interest with respect to the trust.

Congress also enacted exceptions for certain transfers for fair market value, for transfers by reason of death, and for transfers to certain employee benefit trusts.

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Overview of 1996 Legislation – Obligations Issued By a Foreign Trust

In 1996, Congress made several changes to IRC § 679. These changes focused primarily on areas where taxpayers could improperly avoid the application of IRC § 679.

One area that concerned Congress was that certain taxpayers were attempting to come within the fair market value exception of IRC § 679(a)(2), thereby avoiding the application of IRC § 679(a)(1), by issuing trust obligations that might not be repaid (for example, self-canceling installment notes or unsecured private annuity contracts). The 1996 act prevents this abuse by adding IRC § 679(a)(3), which generally provides that obligations issued by the trust, by any grantor or beneficiary of the trust, or by any person related to any grantor or beneficiary, are not taken into account in applying the fair market value exception except as provided in regulations.

Pre-Immigration Transfers

The 1996 legislation also added new IRC §§ 679(a) (4) and (5) to prevent taxpayers from improperly avoiding the application of IRC § 679. IRC § 679(a)(4) ensures that certain foreign persons who transfer property to a foreign trust in anticipation of becoming U.S. persons (pre-immigration trusts) cannot avoid the rules of IRC § 679 by transferring property, directly or indirectly, to a foreign trust and then becoming a resident of the United States within 5 years after the transfer.

Trust Migration Rule

In addition, the 1996 legislation added IRC § 679(a) (5) to prevent U.S. individuals from circumventing IRC § 679 by transferring property to a domestic trust and then causing the domestic trust to become a foreign trust ("migrating" from the United States to a foreign jurisdiction).

Continued on next page

Transfers to Foreign Charitable Trusts

The 1996 legislation also added a new exception to the general rule of IRC § 679(a) (1) for transfers of property to certain charitable trusts. To qualify for this exception, the transfer must be to a foreign organization that is organized and operated in accordance with the provisions of IRC § 501(c) (3).

The 5-Year Rule

The 1996 legislation added IRC § 679(c)(3), which provides that beneficiaries who first become U.S. persons more than 5 years after the date of a transfer are disregarded for purposes of applying IRC § 679 with respect to that transfer.

Increased Reporting Requirements

The 1996 legislation amended IRC § 6048 to expand the reporting requirements that apply to:

(i). a U.S. person who transfers property to a foreign trust, and
(ii). a foreign trust that is treated as owned by a U.S. person under the grantor trust rules.

The penalties under IRC § 6677 for a failure to comply with these reporting requirements were also significantly increased. See Notice 97-34 (1997-2 C.B. 422) and Forms 3520 and 3520A.

General Rule of IRC § 679

A U.S. transferor who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property transferred if there is a U.S. beneficiary of any portion of the trust, unless an exception applies to the transfer.

(Final regulations under IRC § 679 were published July 20, 2001, with varying effective dates as further described below).

Multiple Owners

The grantor trust treatment may not apply to a foreign trust in its entirety. If both U.S. persons and foreign persons transfer property to a foreign trust with a U.S. beneficiary, only the portion attributable to property transfers by U.S. persons will be treated as owned by them (the U.S. transferor). The taxation of the trust by the U.S. is “split” between two dramatically different treatments.

Continued on next page

Apportioning Ownership

Currently, there is no legislative or judicial guidance regarding apportionment and the final regulations under IRC § 679 contain no rules as to how ownership of the trust's income should be determined.

Three possibilities for allocating and apportioning the trust's income are:

- Where income can be traced to specific assets, it could be allocated to the transferor(s) of each asset or,
- Income could be allocated to each transferor based on the current fair market value of their property contributions to the trust or,
- Income could be allocated to each transferor based on the fair market value of their property contributions at the time they were contributed.

The first approach is certainly simplest and most equitable, if the income can be related to specific assets transferred. Unfortunately, that is not always possible.

The second approach has the disadvantage of requiring a current valuation of all trust property.

The third may heavily tax recent transferors of property in favor of those who transferred property long ago that has since appreciated significantly and/or generates large portions of trust income.

Exercise 18B-4

Brothers Paul and John made a small fortune in the software business in 1998. They decided to establish a foreign trust for the benefit of their mother, their sister, and their sister's children. Paul transferred $1 million worth of bonds yielding 8 percent per annum. John transferred a mineral royalty that paid $80,000 in 1998. Based on that annual income, the royalty was valued at $1,000,000. Due to new discoveries, by 2001 the royalty has increased to $120,000 per year, and its fair market value is estimated at $1,500,000.

Continued on next page

Exercise 18B-4

What portion of the trust's income is allocable to John in 2001?

Answer:

IRC § 679 Trumps Other Grantor Trust Provisions

IRC § 679 applies without regard to whether the U.S. transferor retains any power or interest described in IRC §§ 673 through 677. If a U.S. transferor would be treated as the owner of a portion of a foreign trust pursuant to the rules of this section and another person would be treated as the owner of the same portion of the trust pursuant to IRC §678, then the U.S. transferor is treated as the owner and the other person is not treated as the owner.
(Treas. Reg. § 1.679-1(b)).

U.S. Transferor Defined

The term U.S. transferor means any U.S. person who makes a transfer of property to a foreign trust. (Treas. Reg. § 1.679-1(c) (1)).

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U.S. Person Defined

The term "U.S. person" means a United States person as defined in IRC § 7701(a)(30):

- a citizen or resident of the United States,
- a domestic partnership,
- a domestic corporation,
- any estate (other than a foreign estate within the meaning of IRC § 7701(a)(31), or
- a domestic trust (Treas. Reg. § 1.679-1(c) (2)). or
- a nonresident alien individual who elects under IRC § 6013(g) to be treated as resident of the United States, or
- an individual who is a dual resident taxpayer within the meaning of Treas. Reg. § 301.7701(b)-7(a). (Treas. Reg. § 1.679-1(c) (2)).

Presumption of U.S. Beneficiary IRC § 679(d)

If a U.S. person directly or indirectly transfers property to a foreign trust after March 18, 2010, then it is presumed that the trust has a U.S. beneficiary unless,

- the transferor submits required information with respect to the transfer to the IRS as prescribed by the Secretary of the Treasury, and
- the transferor demonstrates that the requirements of IRC §§ 679(c) (1) (A) and (B) are met.

Beneficiaries Include Indirect As Well As Direct Beneficiaries

For purposes of IRC § 679, income or corpus may be paid or accumulated to or for the benefit of a U.S. person during a taxable year of the U.S. transferor if during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of, a U.S. person, or corpus may be distributed to, or held for the future benefit of, a U.S. person. This determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event. (Treas. Reg. § 1.679-2(a) (2)).

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Unexpected Beneficiaries Not Included

A person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. The preceding sentence does not apply with respect to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or any other person.

A class of beneficiaries generally does not include heirs who will benefit from the trust under the laws of intestate succession in the event that the named beneficiaries (or members of the named class) have all deceased (whether or not stated as a named class in the trust instrument).
(Treas. Reg. § 1.679-2(a) (2) (ii)).

Example18B – 1

(In this example, Adam is a resident alien; Boyd is Adam's son, who is a resident alien; Carol is Adam's daughter, who is a nonresident alien; and FT is a foreign trust).

<u>Income accumulation for the benefit of a U.S. person</u>. In 2001, Adam transfers property to FT. The trust instrument provides that from 2001 through 2010, the trustee of FT may distribute trust income to Carol or may accumulate the trust income. The trust instrument further provides that in 2011, the trust will terminate and the trustee may distribute the trust assets to either or both of Boyd and Carol in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust assets must be distributed to Carol. Because it is possible that income may be accumulated in each year, and that the accumulated income ultimately may be distributed to Boyd, a U.S. person, FT is treated as having a U.S. beneficiary during each of Adam's tax years from 2001 through 2011. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Continued on next page

Special Rule for Foreign Trusts with U.S. Beneficiaries,
Continued

Exercise 18B-5

(**Note:** In this exercise and Exercises 2-7, and 2-8, below, Adam is a resident alien, Boyd is Adam's son, who is a resident alien, Carol is Adam's daughter, who is a nonresident alien, and FT is a foreign trust).

Corpus held for the benefit of a U.S. person. The facts are the same as in Example 2-1, except that from 2001 through 2011, all trust income must be distributed to Carol. In 2011, the trust will terminate and the trustee may distribute the trust corpus to either or both of Boyd and Carol, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust corpus must be distributed to Carol.

Exercise 18B-5

Is the trust treated as having a U.S. beneficiary?

Answer:

Exercise 18B-6

Trustee's discretion in choosing beneficiaries. Adam transfers property to FT. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of, any person who is pursuing the academic study of ancient Greek in the trustee's discretion.

Continued on next page

Exercise 18B-6

Is the trust treated as having a U.S. beneficiary?

Answer:

Exercise 18B-7

U.S. beneficiary becomes non-U.S. person. In 2001, Adam transfers property to FT. The trust instrument provides that, as long as Boyd remains a U.S. resident, no distributions of income or corpus may be made from the trust to Boyd. The trust instrument further provides that if Boyd becomes a nonresident alien, distributions of income (including previously accumulated income) and corpus may be made to him. If Boyd remains a U.S. resident at the time of FT's termination, all accumulated income and corpus is to be distributed to Carol. In 2007, Boyd becomes a nonresident alien and remains so thereafter.

Exercise 18B-7

Is the trust treated as having a U.S. beneficiary?

Answer:

Continued on next page

Changes in Beneficiary's Status/5-Year Rule

The possibility that a person that is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person until the tax year of the U.S. transferor in which that individual actually becomes a U.S. person. However, if a person who is not a U.S. person becomes a U.S. person for the first time more than 5 years after the date of a transfer to the foreign trust by a U.S. transferor, that person is not treated as a U.S. person with respect to that transfer. (Treas. Reg. § 1.679-2(a) (3)).

All Agreements, Written or Oral, Determine Existence of U.S. Beneficiary

Even if, based on the terms of the trust instrument, a foreign trust is not treated as having a U.S. beneficiary, the trust may nevertheless be treated as having a U.S. beneficiary based on the following (Treas. Reg. § 1.679-2(a)(4)(i)):

- All written and oral agreements and understandings relating to the trust;
- Memoranda or letters of wishes:
- All records that relate to the actual distribution of income and corpus; and
- All other documents that relate to the trust, whether or not of any purported legal effect.

Additional Factors

For purposes of determining whether a foreign trust is treated as having a U.S. beneficiary, the following additional factors are taken into account—

- If the terms of the trust instrument allow the trust to be amended to benefit a U.S. person, all potential benefits that could be provided to a U.S. person pursuant to an amendment must be taken into account;

Continued on next page

Additional Factors (continued)

- If the terms of the trust instrument do not allow the trust to be amended to benefit a U.S. person, but the law applicable to a foreign trust may require payments or accumulations of income or corpus to or for the benefit of a U.S. person (by judicial reformation or otherwise), all potential benefits that could be provided to a U.S. person pursuant to the law must be taken into account, unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and
- If the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account.
  (Treas. Reg. § 1.679-2).

Indirect U.S. Beneficiaries

An amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of—

- A controlled foreign corporation, as defined in IRC §957(a);
- A foreign partnership, if a U.S. person is a partner of such partnership; or
- A foreign trust or estate, if such trust or estate has a U.S. beneficiary.

(Treas. Reg. § 1.679-2(b) (1)).

Intermediaries and Constructive Benefit

An amount is also treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of a U.S. person through an intermediary, such as an agent or nominee, or by any other means where a U.S. person may obtain an actual or constructive benefit.
(Treas. Reg. § 1.679-2(b) (2)).

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Trusts Acquiring A U.S. Beneficiary

If a foreign trust to which a U.S. transferor has transferred property is not treated as having a U.S. beneficiary for any taxable year of the U.S. transferor, but the trust is treated as having a U.S. beneficiary in any subsequent taxable year, the U.S. transferor is treated as having additional income in the first such taxable year of the U.S. transferor in which the trust is treated as having a U.S. beneficiary.

The amount of the additional income is equal to the trust's undistributed net income, as defined in IRC § 665(a), at the end of the U.S. transferor's immediately preceding taxable year and is subject to the rules of IRC § 668, providing for an interest charge on accumulation distributions from foreign trusts.
(Treas. Reg. §1.679-2(c) (1)).

Trusts Ceasing to Have A U.S. Beneficiary

If a foreign trust ceases to be treated as having a U.S. beneficiary, the U.S. transferor ceases to be treated as the owner of a portion of the trust.

- The U.S. transferor, for any taxable year, has transferred property to a foreign trust.
- The portion of the trust is attributable to the transfer beginning in the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary (unless the U.S. transferor is treated as an owner thereof pursuant to IRC §§ 673 through 677).

The U.S. transferor is treated as making a transfer of property to the foreign trust on the first day of the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary. The amount of the property deemed to be transferred to the trust is the portion of the trust attributable to the prior transfer. For rules regarding the recognition of gain on transfers to foreign trusts, see IRC § 684.
(Treas. Reg. § 1.679-2(c) (2)).

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Transfers

A transfer means a direct, indirect, or constructive transfer.
(Treas. Reg. § 1.679-3(a)).

Transfers by Certain Trusts

If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion to the foreign trust.
(Treas. Reg. § 1.679-3(b) (1)).

Indirect Transfers

A transfer to a foreign trust by any person (intermediary) to whom a U.S. person transfers property is treated as an indirect transfer by a U.S. person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of U.S. tax.
(Treas. Reg. §1.679-3(c) (1)).

Principal Purpose of Tax Avoidance Deemed to Exist

A transfer is deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax if—

- The U.S. person is related to a beneficiary of the foreign trust, or has another relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust; and
- The U.S. person cannot demonstrate to the satisfaction of the Commissioner that—
  - The intermediary has a relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust;
  - The intermediary acted independently of the U.S. person;
  - The intermediary is not an agent of the U.S. person under generally applicable United States agency principles; and
  - The intermediary timely complied with the reporting requirements of IRC § 6048, if applicable.
    (Treas. Reg. §1.679-3(c) (2)).

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Effect of Disregarding the Entity

In general, if a transfer is treated as an indirect transfer, then the intermediary is treated as an agent of the U.S. person, and the property is treated as transferred to the foreign trust by the U.S. person in the year the property is transferred, or made available, by the intermediary to the foreign trust. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the foreign trust.
(Treas. Reg. §1.679-3(c) (3) (i)).

Effect of Intermediary as Agent

If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the foreign trust under generally applicable United States agency principles, the property will be treated as transferred to the foreign trust in the year the U.S. person transfers the property to the intermediary. The fair market value of the property transferred will be determined as of the date of the transfer by the U.S. person to the intermediary. (Treas. Reg. § 1.679-3(c) (3) (ii)).

Effect on Intermediary Who is an Agent

If a transfer of property is treated as an indirect transfer, the intermediary is not treated as having transferred the property to the foreign trust.
(Treas. Reg. § 1.679-3(c) (3) (iii)).

Related Parties

For purposes of the indirect transfer rules, a U.S. transferor is treated as related to a U.S. beneficiary of a foreign trust if the U.S. transferor and the beneficiary are related for purposes of IRC § 643(i)(2)(B), with the following modifications:

- For purposes of applying IRC §267 (other than IRC § 267(f)) and IRC § 707(b)(1), "at least 10 percent" is used instead of "more than 50 percent" each place it appears; and
- The principles of IRC § 267(b) (10), using "at least 10 percent" instead of "more than 50 percent", apply to determine whether two corporations are related. (Treas. Reg. §1.679-3(c) (4)).

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Special Rule for Foreign Trusts with U.S. Beneficiaries,
Continued

Constructive Transfers

A constructive transfer includes any assumption or satisfaction of a foreign trust's obligation to a third party. (Treas. Reg. §1.679-3(d) (1)).

Undistributed Income of a Simple Trust

A U.S. beneficiary of a foreign grantor trust, treated as owned by another U.S. person, may choose not to receive income distributions that the trust is required or planned to distribute, instead allowing the trustee to accumulate the income. The beneficiary would then become a grantor to the extent of property (income) "transferred" to the trust, and would be taxed on future income it produces.

Guarantee of Trust Obligations

If a foreign trust borrows money or other property from any person who is not a related person with respect to the trust (lender) and a U.S. person (U.S. guarantor) that is a related person with respect to the trust guarantees the foreign trust's obligation, the U.S. guarantor is treated as a U.S. transferor that has made a transfer to the trust on the date of the guarantee. To the extent this rule causes the U.S. guarantor to be treated as having made a transfer to the trust, a lender that is a U.S. person shall not be treated as having transferred that amount to the foreign trust.
(Treas. Reg. §1.679-3(e) (1)).

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Special Rule for Foreign Trusts with U.S. Beneficiaries,
Continued

Amount Transferred

The amount deemed transferred by a U.S. guarantor is the guaranteed portion of the adjusted issue price of the obligation, plus any accrued but unpaid qualified stated interest.
(Treas. Reg. §1.679-3(e) (2)).

Principal Repayments

If a U.S. person is treated as having made a transfer by reason of the guarantee of an obligation, payments of principal to the lender by the foreign trust with respect to the obligation are taken into account on and after the date of the payment in determining the portion of the trust attributable to the property deemed transferred by the U.S. guarantor.
(Treas. Reg. §1.679-3(e)(3)).

Guarantee Defined

The term guarantee—

- Includes any arrangement under which a person, directly or indirectly, assures on a conditional or unconditional basis the payment of another's obligation;
- Encompasses any form of credit support and includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability; and
- Includes an arrangement reflected in a comfort letter, regardless of whether the arrangement gives rise to a legally enforceable obligation.
- If an arrangement is contingent upon the occurrence of an event, in determining whether the arrangement is a guarantee, it is assumed that the event has occurred.
  (Treas. Reg. §1.679-3(e) (4)).

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Transfers to Entities Owned by Trusts

If a U.S. person is a related person with respect to a foreign trust, any transfer of property by the U.S. person to an entity in which the foreign trust holds an ownership interest is treated as a transfer of such property by the U.S. person to the foreign trust followed by a transfer of the property from the foreign trust to the entity owned by the foreign trust, unless the U.S. person demonstrates to the satisfaction of the Commissioner that the transfer to the entity is properly attributable to the U.S. person's ownership interest in the entity.
(Treas. Reg. § 1.679-3(f) (1)).

Exceptions to IRC § 679

IRC § 679 does not apply to—

- Any transfer of property to a foreign trust by reason of the death of the transferor;
- Any transfer of property to a foreign trust described in IRC §§ 402(b), 404(a)(4), or 404A;
- Any transfer of property to a foreign trust described in IRC § 501(c)(3) (without regard to the requirements of IRC § 508(a); and
- Any transfer of property to a foreign trust to the extent the transfer is for fair market value. (Treas. Reg. § 1.679-4(a)).

Transfers for Fair Market Value

- A transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of or for the services rendered by the trust.
- For purposes of this determination, an interest in the trust is not property received from the trust. A distribution to a trust with respect to an interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in Treas. Reg. § 301.7701-4(c), liquidating trusts described in Treas. Reg. § 301.7701-4(d), or environmental remediation trusts described in Treas. Reg. § 301.7701-4(e) is considered to be a transfer for fair market value. (Treas. Reg. §1.679-4(b)).

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Transfers for Partial Consideration

If a person transfers property to a foreign trust in exchange for property having a fair market value that is less than the fair market value of the property transferred, the exception to the application of IRC § 679 applies only to the extent of the fair market value of the property received.
(Treas. Reg. § 1.679-4(b) (2) (i)).

Abuse of the Fair Market Value Transfer Exception

Many taxpayers, promoters, and tax planners have attempted to take advantage of the exception for fair market value transfers to avoid the application of IRC § 679. A number of creative methods were devised, including exchanges of property for self canceling installment notes or private annuities. In such cases, the transferor would attempt to avoid ownership of trust income and defer or escape capital gains tax on appreciated property. In order to curb such abuses, Congress amended IRC § 679 in 1996 to require that certain obligations not be treated as consideration for the purpose of determining if fair market value was received. (Notice 97-34, 1997-1, CB 422).

Certain Obligations Not Taken into Account

In determining whether a transfer by a U.S. transferor that is a related person with respect to the foreign trust is for fair market value, any obligation of the trust or a related person that is not a qualified obligation shall not be taken into account. (Treas. Reg. § 1.679-4(c)).

What Is A "Related" Person?

A person is a related person if, without regard to the transfer at issue, the person is:

- A grantor of any portion of the trust (within the meaning of Treas. Reg.§ 1.671-2(e)(1));
- An owner of any portion of the trust under IRC §§ 671 through 679;
- A beneficiary of the trust; or
- A person who is related (within the meaning of IRC § 643(i) (2) (B)) to any grantor, owner, or beneficiary of the trust.

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What Is A "Related" Person? (continued)

IRC § 643(i) (2) (B) states that a person is related to another person if the relationship between such persons would result in a disallowance of losses under IRC § 267 or IRC § 707(b). In applying IRC § 267 for this purpose, IRC § 267(c) (4) shall be applied as if the family of an individual includes the spouses of the members of the family.

Entities Controlled by a Foreign Trust

The above description would seem to include entities controlled by a foreign trust, such as a foreign corporation or foreign partnership as "a person who is related … to any grantor, owner or beneficiary of the trust".

Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries (IRC § 267(c)(1)). A similar rule applies to partnership interests (IRC § 707(b) (1) (A)).

Where there are multiple beneficiaries from the same family, the constructive ownership rules will generally result in the over 50% control test being met.

Only Qualified Obligations Taken into Account

In determining whether a transfer by a U.S. transferor that is a related person with respect to the foreign trust is for fair market value, any obligation of the trust or a related person that is not a qualified obligation is not taken into account. (Treas. Reg. § 1.679-4(c)).

Obligation Must be Reduced to Writing

The obligation must be reduced to writing by an express written agreement.
(Treas. Reg. § 1.679-4(d) (1) (i)).

Term Cannot Exceed 5 Years

The term of the obligation must not exceed five years for the purpose of determining the term of an obligation; the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation. (Treas. Reg. § 1.679-4(d) (1) (ii)).

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Payments in U.S. Dollars

All payments on the obligation must be denominated in U.S. dollars. (Treas. Reg. § 1.679-4(d) (1) (iii)).

Yield to Maturity Not Less than 100 Percent of Fed. Rate

The yield to maturity must not be less than 100 percent of the applicable Federal rate and not greater that 130 percent of the applicable Federal rate. (The applicable Federal rate for an obligation is the applicable Federal rate in effect under IRC § 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin). (Treas. Reg. § 1.679-4(d) (1) (iv)).

Statute Must be Extended

The U.S. transferor must extend the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding to a date not earlier than three years after the maturity date of the obligation. (This extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. transferor's taxable year for the year of the transfer and is paid within such period). (Treas. Reg. § 1.679-4(c) (1) (v)).

Loan Status Reported On Form 3520

The U.S. transferor must report the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.
(Treas. Reg. § 1.679-4(c) (1) (vi)).

Additional Loans

If, while the original obligation is outstanding, the U.S. transferor or a person related to the trust directly or indirectly obtains another obligation issued by the trust, or if the U.S. transferor directly or indirectly obtains another obligation issued by a person related to the trust, the original obligation is deemed to have the maturity date of any such subsequent obligation in determining whether the term of the original obligation exceeds the specified 5 year term. In addition, a series of obligations issued and repaid by the trust (or a person related to the trust) is treated as a single obligation if the transactions giving rise to the obligations are structured with a principal purpose to avoid the application of this provision.
(Treas. Reg. § 1.679-4(d) (2)).

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Loss of Qualified Obligation Status

If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation (for example, renegotiation of the terms of the obligation causes the term of the obligation to exceed five years), the U.S. transferor is treated as making a transfer to the trust in an amount equal to the original obligation's adjusted issue price (within the meaning of Treas. Reg. § 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of Treas. Reg. § 1.1273-1(c)) as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation. If the maturity date is extended beyond five years by reason of the issuance of a subsequent obligation by the trust (or person related to the trust), the amount of the transfer will not exceed the issue price of the subsequent obligation. The subsequent obligation is separately tested to determine if it is a qualified obligation.
(Treas. Reg. § 1.679-4(d) (3)).

Transfers Resulting From Failed Qualified Obligations

A transfer resulting from a failed qualified obligation is deemed to occur on the date of the subsequent event that causes the obligation to no longer be a qualified obligation. However, based on all of the facts and circumstances, the Commissioner may deem a transfer to have occurred on any date on or after the issue date of the original obligation. For example, if at the time the original obligation was issued, the transferor knew or had reason to know that the obligation would not be repaid; the Commissioner could deem the transfer to have occurred on the issue date of the original obligation.
(Treas. Reg. §1.679-4(d) (4)).

Renegotiated Loans

Any loan that is renegotiated, extended, or revised is treated as a new loan. Any transfer of funds to a foreign trust after such renegotiation, extension, or revision under a pre-existing loan agreement is treated as a transfer.
(Treas. Reg. §1.679-4(d) (5)).

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Principal Repayments

The payment of principal with respect to any obligation that is not treated as a qualified obligation under this paragraph is taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.
(Treas. Reg. §1.679-4(d) (6)).

Pre-Immigration Trusts

If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under IRC § 7701(b) (2) (A)) within 5 years after directly or indirectly transferring property to a foreign trust (the original transfer), the individual is treated as having transferred to the trust on the residency starting date an amount equal to the portion of the trust attributable to the property transferred by the individual in the original transfer.
(Treas. Reg. § 1.679-5(a)).

Change in Grantor Trust Status

If a nonresident alien individual who is treated as owning any portion of a trust under the provisions of Subpart E of part I of Subchapter J, chapter 1 of the Internal Revenue Code, subsequently ceases to be so treated, the individual is treated as having made the original transfer to the foreign trust immediately before the trust ceases to be treated as owned by the individual.
(Treas. Reg. § 1.679-5(b) (1)).

Treatment of Undistributed Income

The property deemed transferred to the foreign trust on the residency starting date includes undistributed net income, as defined in IRC § 665(a), attributable to the property deemed transferred. Undistributed net income for periods before the individual's residency starting date is taken into account only for purposes of determining the amount of the property deemed transferred.
(Treas. Reg. § 1.679-5(b) (2)).

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Outbound Migrations of Domestic Trusts

If an individual who is a U.S. person transfers property to a trust that is not a foreign trust, and such trust becomes a foreign trust while the U.S. person is alive, the U.S. individual is treated as a U.S. transferor and is deemed to transfer the property to a foreign trust on the date the domestic trust becomes a foreign trust.
(Treas. Reg. § 1.679-6(a)).

Amount Deemed Transferred

The property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in IRC § 665(a), attributable to the property previously transferred. Undistributed net income for periods prior to the migration is taken into account only for purposes of determining the portion of the trust that is attributable to the property transferred by the U.S. person.
(Treas. Reg. § 1.679-6(b)).

Effective Dates

- The general rule and definitions, beneficiary rules, and transfer rules of the regulations apply with respect to transfers made after August 7, 2000. (Treas. Reg. § 1.679-7(a)).
- The qualified obligations rules of the regulations apply to obligations issued after February 6, 1995.
(Treas. Reg. § 1.679-7(b) (1)).
- The pre-immigration trust rules of the regulations apply to persons whose residency starting date is after August 7, 2000.
(Treas. Reg. § 1.679-7(b) (2)).
- The trust migration rules of the regulations apply to trusts that become foreign trusts after August 7, 2000.
(Treas. Reg. § 1.679-7(b) (3)).

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Special Rule for Foreign Trusts with U.S. Beneficiaries,
Continued

Trust or Related Party Obligations Issued on or Before February 6, 1995

As in effect prior to its amendment in 1996, IRC § 679 excluded:
…any sale or exchange of the property at its fair market value in a transaction in which all of the gain to the transferor is realized at the time of the transfer and is recognized either at such time or is returned as provided in IRC § 453.

Before the promulgation of the qualified obligation rules, some taxpayers transferred property to foreign trusts in exchange for obligations of the trust or of entities owned by, or otherwise related to, the trust. Examples of such obligations include self-canceling installment notes ("SCIN's") and unsecured private annuities.

Such obligations may still be challenged if they lack economic substance. Particular scrutiny should be given to unsecured private annuities because a body of rulings and decisions holds that an unsecured private annuity has no ascertainable fair market value (Rev. Rul. 69-74, 1969-1 C.B. 43). Therefore, an unsecured private annuity issued by a foreign trust or an entity owned by the trust should not be taken into account as consideration in determining whether a sale or exchange was for fair market value.

“Inbound” Trusts

“Inbound” Trusts

- What if a person who might be potentially treated as an owner of a trust is not a U.S. person? If a foreign person is treated as an owner of a trust under the grantor trust rules, income of the trust may escape U.S. taxation. (Rev. Rul. 69-70, 1969-1 CB 182).
- Prior to 1990, a foreigner who expected to immigrate to the United States would give property to another foreign person, who would then transfer the property to a foreign trust for the benefit of the original owner. The intermediary would retain powers that ensured that he or she would be treated as the owner of the trust under IRC §§ 671-678. Because a nonresident alien was treated as the owner, the United States could tax only the income from U.S. sources that was subject to tax under IRC § 871. The original transferor could then receive income distributions free from U.S. income tax after immigration to the United States.
- Congress attempted to limit the use of the grantor trust rules to avoid taxation on the income of the “inbound” trusts. The vehicle for this limitation is IRC § 672(f), first added to the Code in 1990. As first enacted, this section provided that if, under the ordinary grantor trust rules, a foreign person would be treated as the owner of a portion of a trust with a U.S. beneficiary. That U.S. beneficiary would be treated as a grantor to the extent of any gifts he or she had previously made to the foreign grantor. This rule is now found in IRC § 672(f) (5).

Reading Assignment

Read IRC §672(f).

Continued on next page

Further Limitations of Grantor Trust Rules

- Another situation was also perceived to be an abuse of the grantor trust rules. A wealthy nonresident alien might create a foreign trust while retaining sufficient powers to make it a grantor trust. The children of wealthy foreign parents could live in the United States and receive income distributions, sometimes millions annually, from foreign trusts without paying any U.S. income tax.
- IRC § 672(f) was amended in 1996 to provide more generally that the grantor trust rules operate only when the result is to take income (or deductions, credits, etc.) into account in computing the income of a U.S person. Therefore, the grantor trust rules do not generally apply to treat a nonresident alien as the owner of a trust.

Anti-Avoidance Rules

- When necessary to prevent avoidance of IRC § 672(f), the Secretary is authorized to re-characterize purported gifts from partnerships or foreign corporations. When necessary to prevent the avoidance of the purpose of IRC § 672(f), purported gifts from partnerships generally must be included in the U.S. donee's gross income as ordinary income and purported gifts from foreign corporations generally must be included in the U.S. donee's gross income as if they were distributions from the foreign corporation. There are a number of exceptions to the general rule.
- IRC § 643(h) is designed to "backstop" IRC § 672(f). If a U.S. person receives property from a foreign trust through an intermediary (other than the grantor of the trust), the property will be deemed to have been transferred directly by the foreign trust to the U.S. person 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. Circumstances under which a transfer is deemed to have been made pursuant to such a plan are set forth in the regulations under IRC § 643.

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Exceptions

There are some exceptions to the limitation of IRC § 672(f).
IRC § 672(f) does not limit the application of the grantor trust rules to:

- any portion of a trust from which the only amounts distributable during the grantor's lifetime are to the grantor or the grantor's spouse. In such a situation, there is no possibility of tax-free distribution to a grantor who has become a U.S. citizen or resident;
- any portion of a trust that is revocable by the grantor without the approval of another person or with the approval of a related or subordinate party who is subservient to the grantor; and
- compensatory trusts (trusts from which distributions are taxable as compensation).
- trusts in existence on September 199, 1995, provided such trusts are treated as grantor trusts under IRC §§ 676 or 677 (other than IRC § 677(a) (3)).

Controlled foreign corporations are generally treated as domestic corporations for purposes of IRC § 672(f). Finally, for purposes of determining whether a foreign corporation is a passive foreign investment company under IRC § 1297, the grantor trust rules are applied as if IRC § 672(f) were not in effect.
(Treas. Reg. § 1.672(f)-2(c)).

Taxation of Grantor Trust Income

Trust Is "Transparent"

When any portion of a trust is treated as a grantor trust, the income related to that portion is taxed to the person(s) treated as the owner(s) as if the trust did not exist. According to IRC § 671:

"there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual".

- The income distribution deduction provided in IRC § 652 (simple trusts) and IRC § 662 (complex trusts) applies only to non-grantor trusts. Therefore, the person who is treated as the owner is not allowed any deduction for income distributed or distributable by the grantor trust.
- Numerous tax avoidance schemes have been promoted relying on the notion that a U.S. person can assign income, or otherwise transfer property, through a series of foreign trusts and intermediaries in such a way that there is no longer any U.S. income tax effect. A careful reading of the statutes reveals the weaknesses of these schemes.

Continued on next page

U.S. Law Controls

The trust items included in computing the grantor's U.S. income tax liability are defined by U.S. law, not by the terms of the trust or the local laws under which it was established or operates. When the grantor trust rules apply, IRC § 671 states:

"there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual".

- It is common for trusts to treat capital gains as additions to the corpus of the trust, not as income. The laws of some foreign countries may even state as much. However, for U.S. income tax purposes, capital gains are treated just as if they had been realized by the person(s) treated as owner(s) of the trust.
- The language of IRC § 671 also precludes any deduction for income distributable to beneficiaries, as allowed to nongrantor trusts under IRC §§ 651 and 661.

Related Party Transactions

- When all or a portion of a trust is treated as a grantor trust, the trust is disregarded with respect to that portion in every sense. Assets, liabilities, income, deductions, and credits allocable to a person treated are treated as if they were the taxpayer's own. Transactions between the trust and parties related to the grantor are treated as if they were directly between the grantor and the related party. In such situations, reallocations under IRC § 482 may be necessary.
- Transactions directly between the grantor and the trust are disregarded. It follows that such self-dealing cannot create either income or deductions for the grantor or the trust.

Continued on next page

Source of Income

Because U.S. persons are taxed on worldwide income, the source of trust income is not a factor in determining taxable income. However, the transparency of the grantor trust may result in some unusual situations when foreign tax credits involved. The source of each item, foreign or United States, must be determined on its source to the trust for purposes of computing the foreign tax credit limitation under IRC § 904.

Example18B – 2

A foreign trust is located in a country that taxes the trust on its worldwide income. The only income the trust receives in a given year is the capital gain from a sale of property located in the United States, on which the trust is taxed by its home country. If a U.S. person is treated as the owner of the trust, that person must include the gain but will not be entitled to a foreign tax credit only a deduction. Why? Because the foreign tax credit limit is zero. The taxpayer has no foreign sourced income.

Attribution of Stock Ownership, Partnership Interests, Etc.

Ownership of Trust Equals Ownership of Trust Property

IRC § 671 states that a person treated as an owner of any portion of a trust is to include in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion.

The regulations under IRC § 671 provide that:

- If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.
  (Treas. Reg. § 1.671-3(a) (1)).
- If the grantor is treated as the owner of a portion of a trust and that portion consists of specific trust property and its income, then all items directly related to that property are to be taken into account in computing the grantor's income tax liability.
  (Treas. Reg. § 1.671-3(a) (2)).
- Courts have generally followed the principle that…the Code *looks through* the trust form and deems such grantor or other person to be the owner of the trust property and attributes the trust income to such person. By attributing such income directly to a grantor or other person, the Code, in effect, disregards the trust entity. Income is deemed, therefore, to have been received by the "owner" of the property *Estate of O'Connor v. Commissioner*, 69 T.C. 165.

Attribution Rules

Certain types of income may be deemed to flow directly through a trust to the beneficiaries or to grantors treated as owners. The Internal Revenue Code contains attribution provisions to facilitate those sections relating to ownership and control of entities.

IRC § 318(a)(2)(B)(ii) states that stock owned directly or indirectly by a trust is constructively owned by any person(s) treated as an owner by the trust.

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Attribution Rules (continued)

Certain types of income may be deemed to flow directly through a trust to the beneficiaries or to grantors treated as owners. The Internal Revenue Code contains attribution provisions to facilitate those sections relating to ownership and control of entities.

IRC § 318(a)(2)(B)(ii) states that stock owned directly or indirectly by a trust is constructively owned by any person(s) treated as an owner by the trust.

Subpart F

IRC § 958(a)(2) attributes to the beneficiaries or persons treated as owners of a foreign trust indirect ownership of stock owned by the trust, for the purposes of applying Subpart F (relating to controlled foreign corporations). Such attribution may then result in Subpart F income flowing to the indirect owner(s) of the stock. Also, disposition of the stock by the trust may result in deemed dividends to beneficiaries under IRC §1248 to the extent of accumulated earnings and profits.

Grantor Trust Reporting Requirements

Form 3520

Each U.S. person treated as an owner of a foreign trust must file Form 3520 titled, *"Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts"*. Part II of the Form is required to be completed even if there have been no transactions involving the trust during the tax year.

The filing of Form 3520 is also required to be filed by U.S. persons who receive (directly or indirectly) a distribution from a foreign trust (including the uncompensated use of trust property after March 18, 2010) during the current year OR a related foreign trust holding an outstanding obligation issued by the U.S. person (or a person related to the U.S. person) that is treated as a qualified obligation during the tax year.

Form 3520 is filed on the due date the person treated as the owner (transferor) files their tax returns including extensions. The form is filed at the Ogden Campus.

(Beginning with the filing of Form 3520 for the U.S. person's 2000 tax year, Form 3520 is no longer required to be attached to the U.S. person's income tax return).

Form 3520-A

A foreign trust must file Form 3520-A titled "*Annual Information Return of Foreign Trust With a U.S. Owner*", to satisfy its annual information reporting requirements.

Under IRC § 6048, as amended in 1996, each U.S. person treated as an owner of a foreign trust under IRC §§ 671 through 679 is responsible for ensuring that the foreign trust files an annual return setting forth a full and complete accounting of all trust activities, trust operations, and other relevant information. In addition, the U.S. owner is responsible for ensuring that the trust annually furnishes such information to U.S. owners and U.S. beneficiaries of the trust.

This amendment was effective for tax years beginning after December 31, 1995. For prior years, each U.S. person treated as an owner was required to file Form 3520-A individually. The Form 3520-A includes a balance sheet and income statement for the trust, as well as statements for each owner and beneficiary.

Continued on next page

Form 3520-A (continued)

Form 3520-A is filed by the 15th day of the 3rd month after the end of the trust's tax year and copies of the Foreign Trust Ownership Statement and the Foreign Grantor Trust Beneficiary Statement must be given to the U.S. owners and U.S. beneficiaries by the 15th day of the 3rd month after the end of the trusts tax year. An extension of time may be granted by filing Form 7004.

Prior Law – Form 3520

Every U.S. person who either created a foreign trust or transferred money or property to a foreign trust filed a Form 3520, unless an extension of time to file was received, by the 90th day after such transfer or creation. This filing requirement could cause multiple Forms 3520 to be filed with the Philadelphia Campus for each trust.

Previously Form 3520 was titled, *"Creation of or Transfers to Certain Foreign Trusts".*

Prior Law – Form 3520-A

For years beginning prior to January 1, 1996, Form 3520-A was required to be filed by any person treated as an owner of a foreign trust with a U.S. beneficiary.

The earlier versions of Form 3520-A were entitled, "Annual Return of Foreign Trust With U.S. Beneficiaries". The form included a balance sheet and income statement for the trust, with a separate column for income and deductions to be reported by the filer.

The filing date for the prior Form 3520-A was the 15th day of the 4th month. Extensions to file were also granted by filing Form 2758.

Previously Form 3520-A was titled, "Annual Return of Foreign Trusts With U.S. Beneficiaries".

Penalties

See Appendix 2-1 for penalties related to both Forms 3520 and 3520-A.

Taxation of Trust Income to Persons Treated as Owners of Grantor Trusts

Character of Trust Income in the Hands of Persons Treated as Owners of Grantor Trusts

If a foreign trust is treated as a grantor trust, the income, deductions, and credits attributable to the trust have the same character as if they had been generated by the grantor or other persons treated as the owner.

Participation for the purposes of passive activity rules is based on such grantor's or other person's participation.

A disposition of an asset previously transferred to the trust by a grantor is treated as a disposition by such grantor or other person, and the holding period is computed from the initial acquisition by such grantor or other person

For purposes of distinguishing between capital gains or loss and ordinary gain or loss, property is classified as if it were used by such grantor or other person.

Ownership of S-Corporation Stock

Notwithstanding the general rule of IRC § 1361(b) (1) (B), IRC § 1361(c) (2) (A) (i) allows a trust to be a shareholder of a "small business corporation" if, under IRC §§ 671 through 679, the entire trust is considered owned by an individual who is a U.S. citizen or resident.

Deductibility of Trust Administration Expenses

When a trust is treated as a grantor trust, expenses of administering the trust become a miscellaneous deduction to the grantor. As such, they are subject to the 2-percent floor imposed by IRC § 67. *Susan L. Bay v. Commissioner*, T.C. Memo 1998-411; 76 T.C.M. 866.

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Credit for Foreign Taxes Paid by the Trust

The foreign trust may have paid taxes to foreign countries. To the extent that such taxes constitute an allowable tax on the trust's income, the grantor may be entitled to claim a foreign tax credit (FTC) under IRC §§ 901 through 908 including IRC § 960.

If the credit is claimed, the amount of income reported should be "grossed up" to include the foreign taxes paid (IRC § 78).

The taxpayer may elect to deduct the foreign taxes instead of claiming the credit.

Fiduciaries and individuals claiming foreign tax credit must generally file Form 1116, Foreign Tax Credit (Individual, Fiduciary, or Nonresident Alien Individual). Corporate filers must use Form 1118, Foreign Tax Credit – Corporations.

Disposition of Grantor Trust Property

Because one or more persons are treated as the owner of a grantor trust, any disposition of property by the trust is treated as a disposition by the persons treated as the owner. Such transfers may result in a taxable event.

It is also important to note that some transactions of a foreign trust issues may raise non-recognition provisions of the Internal Revenue Code.

If a grantor trust transfers property to a nongrantor foreign trust, the gain recognition provisions of IRC § 684 would apply.

Continued on next page

Example18B – 3

When a taxpayer transfers appreciated property to a foreign corporation in exchange for the corporation's stock, IRC § 351 normally allows the taxpayer to defer recognition of gain. However, IRC § 367 provides that when a U.S. person transfers property to a foreign corporation the transferee is not treated as a corporation for the purposes of most non-recognition provisions of the Code, including IRC § 351. Therefore, if a grantor trust transfers appreciated property to a foreign corporation in exchange for the corporation's stock, the person treated as owner must recognize gain.

Termination of Owner Treatment

- If a person treated as an owner of a foreign trust ceases to be treated as such, that person is deemed to have disposed of his or her share of trust property. This can result from the loss or renunciation of the powers that caused such person to be treated as an owner. It can also result, where IRC § 679 applies, from the trust's loss of all U.S. beneficiaries. The gain recognition provisions of IRC § 684 apply as if the persons treated as owners had transferred all the trust's property to a nongrantor foreign trust.
- IRC § 1361(c) (2) (A) (i) allows a trust to be a shareholder of a "small business corporation" if, under IRC §§ 671 through 679, the entire trust is considered owned by an individual who is a U.S. person. In such a case, termination of owner treatment would disqualify the trust. However, in the case of death of the person treated as owner, the trust will remain an eligible shareholder of a small business corporation after the individual's death for either 60 days or 2 years, depending on whether the entire trust corpus is included in the gross estate of the deemed owner.

Consequences of Trust Termination

A grantor trust is treated as a nonentity for income tax purposes; dissolution of the trust is not, in itself, a taxable event. However, any disposition of the trust assets to anyone other than the person treated as owner constitutes a disposition of trust assets by such person and could result in a taxable event.

Summary

Review

Under IRC §§ 671-679, the income of a foreign trust may be treated as owned by one or more other persons. This treatment may apply to persons who hold powers described in IRC §§ 673-678 or to U.S. persons who make property transfers described in IRC § 679.

A taxpayer treated as an owner of a trust is required to report his or her share of trust income, deductions, and credits as if those items were received or paid directly by the taxpayer.

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Appendix 11B-1 – Reporting Requirement and Penalties

Form 3520

Form 3520 is used to report events that may have tax consequences for the trust or other parties. Form 3520 must be filed by the following persons on the occurrence of any of the listed reportable events:

- The transferor (or the executor of their estate) responsible for any reportable event, including:
  - Creation of a foreign trust by a U.S. person.
  - Direct or indirect transfer of money or property to a foreign trust by a U.S. person.
  - Death of a U.S. citizen or resident if the decedent was treated as an owner of a foreign trust under the grantor trust rules, or if any portion of a foreign trust was included in the decedent's gross estate.
  - A trust that was not a foreign trust becomes a foreign trust.
- Any U.S. person who, for any part of the tax year, was treated as an owner of any part of the assets of a foreign trust under the grantor trust rules. Note: Part II is required to be completed even if there have been no transactions involving the trust during the year.
- Any U.S. person who, during the tax year, received a distribution from a foreign trust (including the uncompensated use of trust property after March 18, 2010), or who had an obligation outstanding to a foreign trust treated as a "qualified obligation"
- Any U.S. person who, during the tax year, received either:
  - More than $100,000 from a nonresident alien individual or foreign estate (or foreign person related to such nonresident alien individual or estate) treated as gifts or bequests, or
  - More than $ $14,165 (2010 amount indexed) from foreign corporations or foreign partnerships (or foreign person related to such corporation or partnership) treated as gifts.

A separate Form 3520 must be filed for transactions with each foreign trust. A joint Form 3520 may be filed if two transferors/grantors or two beneficiaries of the same trust file joint income tax returns.

Continued on next page

Form 3520-A

A foreign trust with at least one U.S. owner must file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, to satisfy its annual information reporting requirements. The form provides information about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust. Under IRC § 6048, as amended in 1996, each U.S. person treated as an owner of a foreign trust under IRC §§ 671 through 679 is responsible for ensuring that the foreign trust files an annual return setting forth a full and complete accounting of all trust activities, trust operations, and other relevant information.

A Foreign Trust with at least one U.S. owner must file a complete Form 3520-A with the Ogden Campus by the 15th day of the 3rd month after the end of the trust's tax year. This amendment was effective for tax years beginning after December 31, 1995. In addition, the U.S. owner is responsible for ensuring that the trust annually furnishes such information to U.S. owners and U.S. beneficiaries of the trust. Form 3520-A includes a balance sheet and income statement for the trust, as well as statements for each owner and beneficiary.

Penalties Increased

Penalties for failing to file Forms 3520 or 3520-A or report all the information required were increased substantially by the 1996 and 2010 laws in order to increase compliance.

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Reporting Penalties for Failure to Timely File or Filing an Inaccurate or Incomplete Form 3520 or Form 3520-A

IRC § 6677 prescribes civil penalties for failure to timely file a return required by IRC § 6048 or for filing a return that does not show the information required by IRC § 6048. The IRC § 6677 penalty applies if any notice or return required to be filed by IRC § 6048:

- Is not filed on or before the due date, or
- Does not include all required information, or
- Includes inaccurate information.

The civil penalty in addition to any criminal penalty for failure to file Form 3520 is:

The greater of $10,000 or:

- 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust or
- 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution or
- 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

Additional penalties will be imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting.

The civil penalty in addition to any criminal penalty for failure to file Form 3520-A is:

- The greater of $10,000 or 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of that tax year.

Continued on next page

Reporting Penalties for Failure to Timely File or Filing an Inaccurate or Incomplete Form 3520 or Form 3520-A (continued)

Additional penalties will be imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting.

For tax years beginning after March 18, 2010, penalties may be imposed under new IRC §6662(j) for undisclosed foreign financial asset understatement.

Although the furnishing of information by a U.S. person regarding the receipt of gifts from foreign persons is reported on Form 3520, this information is required under IRC § 6039F (a) rather than under IRC § 6048. If the U.S. person fails to timely furnish the information required by IRC § 6039F(a),

- IRC § 6039F(c) imposes a penalty equal to 5 percent of the amount of such foreign gift received for each month for which such failure continues.
- However, the penalty shall not exceed 25 percent of the amount of such foreign gift in the aggregate.
- In addition, the tax consequences of the receipt of such gift shall be determined by the Secretary.

International Technical Training

Chapter 19 A

Offshore Entities and Foreign Information Reporting

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 3 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk • IRWeb Access
Participant References	• Form 3520 and its instructions • Form 3520-A and its instructions • Form 5471 and its instructions • Form 5472 and its instructions • Form 926 and its instructions • Form 8865 and its instructions • TD F 90-22.1 (FBAR) and its instructions as of March 2011 • IRM 4.26.16 • IRM 4.26.17 • IRM 20.1.9 as of April 22, 2011
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by instructor) • Flipcharts and markers

Overview

Contents

This lesson covers the following topics:

Offshore Entities and Foreign Information Reporting

Introduction

Congress has adopted several sets of rules to prevent U.S. persons from using foreign entities and accounts to defer or avoid U.S. taxes in ways they have deemed to be improper. Those rules include special tax consequences for U.S. persons who transfer property to or own the following:

1. Foreign Trusts
2. Controlled foreign corporations,
3. Foreign investment companies,
4. Passive foreign investment companies, and
5. Controlled foreign partnerships

The Service requires information about U.S. owned foreign entities and accounts to determine compliance in the offshore area. Several Code sections require information reporting by U.S. persons who:

- Own foreign entities
- Are treated as having ownership in these entities, or
- Transfer property to certain foreign entities
- Own foreign accounts

In addition, there are severe penalties imposed on the U.S. taxpayer for failure to report these transactions and/or relationships.

Objectives

At the end of this lesson, you will be able to:

- Define foreign entities in which U.S persons might have an ownership interest in or have transactions with.
- Describe the Information Return filing requirements of U.S. persons who have transactions with and/or ownership interest in certain foreign entities, and
- Describe the penalties for failure to report relationships with certain foreign entities and accounts.

Foreign Trusts

Instructor Notes

Please emphasize the differences between domestic and foreign trust.

Reading Assignment

- IRC §§ 7701(a)(30) and 7701(a)(31).
- Treas. Reg. § 301.7701-4(a).

Trust

A trust is a legal arrangement in which an individual (**grantor**) transfers property to a **trustee**, who holds and administers the property for the benefit of another (the **beneficiary**).

Treas. Reg. §301.7701-4(a) defines a trust for Federal income tax purposes as an arrangement where trustees take title to property for the purpose of protecting or conserving it for the beneficiaries.

Foreign Trust

Trusts may be defined as either domestic or foreign. For tax years beginning after December 31, 1996, a trust is foreign unless a U.S. court supervises the trust and a U.S. person has the authority to control all substantial decisions.

There are significant tax consequences for trusts determined to be foreign. There are also numerous reporting requirements associated with the establishment, operation of, and transfer of property to foreign trusts by U.S. persons.

The1996 law simplified the residence of trusts by amending IRC §7701(a)(30) and §7701(a)(31). This had the effect of replacing the previously subjective "facts and circumstances" test with an objective test. Under the 1996 law, a trust is treated as foreign unless **both** of the following conditions apply to make it a domestic trust:

Continued on next page

Court Test and Control Test

- A court within the United States is able to exercise primary supervision over the administration of the trust (the court test), and
- One or more United States persons have the authority to control all substantial decisions of the trust (the control test).

Reading Assignment

- IRC § 7701(a)(31)(B).
- Treas. Reg. § 301.7701-4(b).

The terms of the trust instrument and applicable law must be applied to determine whether the court test and control tests are met. (Treas. Reg. §301.7701-7(b))

Example 19A-1

In 2011, the Fender Trust is a trust administered under the laws of the Cayman Islands. The trustee is Oldberry Ltd, also located in the Cayman Islands. No U.S. court has primary supervision over the trust and no U.S. persons have the authority to control all substantial decisions of the trust. In this example neither the Court Test nor Control test is met. Therefore, the Fender Trust is a foreign trust under IRC §7701(a)(31)(B).

It is very important to note that whether a trust is domestic or foreign, when trust income is attributed to a U.S. person as an owner or beneficiary of the trust, the source of the income is immaterial; “U.S. persons” are taxed on their worldwide income (Treas. Reg. 1.1-1(b))

Trust Taxation

Income earned by a trust may be taxed to the trust itself, to beneficiaries to the extent it is considered distributed, or to the grantors or other persons treated as owners of the trust.

The first step is to determine whether the trust is treated as a trust for U.S. income taxes at all.

Continued on next page

Disregarded Entity

A trust that is considered to be valid under state law, or the laws of a foreign country, may be disregarded for U.S. tax purposes.

There have been blatant tax evasion schemes that utilize one or more foreign trusts, often in combination with domestic trusts.

These schemes employ variations on structures that the promoters claim will transform the U.S. taxpayer's income such that it is not subject to tax, yet it is still available to the taxpayer. They are based on faulty interpretations of the Internal Revenue Code, and selective quotations and misinterpretation of court cases.

Instructor Notes

Please explain the differences between a regular trust and an abusive tax shelter trust.

Disregarded Entity, (continued)

Usually, in these cases, the form of the arrangement was not what it was purported to be, or the taxpayer and/or promoter did not conduct business in accordance with the structure they had set up on paper. Invariably, the courts have ruled that these structures lack economic substance, or violate the "fruit of the tree" doctrine by attempting to assign the taxpayer's income to another entity.

In disregarding these arrangements, or concluding that taxpayers made anticipatory assignments of income, the courts have seldom reached the point of technical arguments that would apply if the trusts were treated as valid entities for tax purposes.

If the trust is a sham, or is created primarily for tax avoidance, it may be disregarded altogether, and its income is taxed to the person(s) whose actual economic activity it represents.

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Substance vs. Form

The U. S. Supreme Court has consistently stated that the substance, rather than the form, of the transaction is controlling for tax purposes. [1]Under this doctrine, an arrangement may appear to create a trust. However, we must look at several indicators to determine if the trust is a sham. If the trust arrangement may be viewed as a sham transaction, the IRS may ignore the trust and its transactions for federal tax purposes.[2]

Instructor Notes

Please explain "sham" trust and its consequences. Please also review the concepts of Form 1120F, Subpart F, and PFIC because the Participants are new to the IIC division.

Reading Assignment

- IRC §§ 551-558, 881-885, 951-964, and 1291-1298.
- Treas. Reg. §§ 301.7701-2, 301.7701-3, and 301.7701-4.

Business Trust

To be taxed as a trust the arrangement should be distinguishable from an association or partnership which operates a business for profit. If the purpose of a trust is not to simply protect and conserve property for beneficiaries, but is to make a profit by conducting an active business normally carried on through business organizations, it may be classified as a corporation or partnership and taxed as a business entity rather than a trust under the Internal Revenue Code. These entities are considered to be business entities and their classification as a disregarded entity, partnership, or association taxable as a corporation is governed by Treasury Regulations §§ 301.7701-2, 301.7701-3, and 301.7701-4.

Continued on next page

[1] *Gregory v. Helvering*, 293 U.S. 465,55 S.Ct 266, 79 L.ED. 596 (1935); *Helvering v. Clifford*, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788 (1940)

[2] Notice 97-24, CB 1997-16; *Markosian v. Commissioner*, 73 T.C. 1235 (1980); *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984); Rev. Rul. 80-74, 1980-1 C.B. 137, amplified by Rev. Rul. 90-106, 1990-2 C.B. 162.

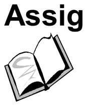
Business Trust (continued)

A foreign business trust that is not treated as a sham will more appropriately be classified as a business entity. However, the trust presumably will not have filed an election as to its classification. Since a foreign trust would normally provide limited liability for its associates, such a trust would most likely be classified under the regulations as an association, regardless of the number of associates.

A foreign trust characterized as a foreign association will be subject to the rules of IRC §§881-885 regarding taxation of foreign corporations. If the trust is engaged in a trade or business in the United States, it is required to file Form 1120F, U.S. Income Tax Return of a Foreign Corporation.

Any U.S. person deemed to be an “associate” would be subject to the reporting requirements of IRC §6038, and may be taxable under Subpart F (IRC §§951-964) on “Subpart F income” and investments of earnings in U.S. property. The passive foreign investment company (PFIC) rules (IRC§§1291-1298) or the foreign personal holding company (FPHC) rules (IRC§§551-558) also may be applicable. FPHC rules were repealed for years beginning after 12/31/04.

Reading Assignment



IRC §§ 671- 678, and 679.

Grantor Trust

In general, a grantor trust is one type of trust in which the grantor, the person who created the trust and made a gratuitous transfer of property to it, retains control of the trust assets, or trust income, or operation of the trust for his benefit, or may even have the power to revoke the trust. The grantor is taxed as the trust’s owner under the "grantor trust rules" of IRC §§671-678.

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IRC §679

In 1976, IRC §679 was added to the Code, extending grantor trust treatment to certain foreign trusts regardless of whether the grantor **or any other person (U.S. or foreign)** holds any of the powers set forth in IRC §§671-678. IRC §679 is specifically designed to prevent U.S. taxpayers from achieving tax deferral by transferring property to foreign trusts.

IRC §679 treats as an owner any U.S. person who transfers property to a foreign trust that has one or more U.S. beneficiaries.

Prior to the enactment of IRC §679, U.S. persons often established foreign nongrantor trusts that invested in assets that generated foreign-source income only. These foreign trusts avoided all U.S. tax on their income. In addition, these trusts generally invested in countries that did not tax interest or dividends paid to foreign investors, and the trusts generally were formed and administered in countries that did not tax trusts. Accordingly, many of these trusts paid no income tax worldwide. Although U.S. beneficiaries were subject to U.S. tax when a foreign nongrantor trust distributed income to them, the use of foreign nongrantor trusts permitted tax-free accumulations of income, giving foreign trusts a significant advantage over domestic trusts.

Congress felt tax-free accumulation of income was inappropriate and provided an unwarranted advantage to foreign trusts over domestic trusts. IRC §679 in general provides that where a U.S. person directly or indirectly transfers property to a foreign trust, the income of the foreign trust is taxable to the transferor if the trust has a U.S. beneficiary. Accordingly, the trust is treated as a grantor trust whether or not the transferor retains any power or interest with respect to the trust. Congress did enact **exceptions** for certain **transfers for fair market value**, for **transfers by reason of death**, and for **transfers to certain employee benefit trusts**.

A taxpayer treated as an owner of a trust is required to report his or her share of trust income, deductions, and credits as if those items were received or paid directly by the taxpayer.

Continued on next page

Presumption of U.S. Beneficiary

The determination of whether a foreign trust has a U.S. beneficiary is made on an annual basis. A foreign trust is treated as having a U.S. beneficiary **unless** during the taxable year of the U.S. transferor—

- No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and
- If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

***** Effective for transfers after 3/18/2010, it has been codified under IRC §679(d) a presumption of a U.S. Beneficiary unless the U.S. transferor demonstrates otherwise upon request.**

Example 19A-2

In 2001, **Adam, a U.S. person**, transfers property to a foreign trust (**FT**). The trust instrument provides that from 2001 through 2010, the trustee of **FT** may distribute trust income to **Carol (a non-resident alien)** or may accumulate the trust income. The trust instrument further provides that in 2011, the trust will terminate and the trustee may distribute the trust assets to either or both of **Boyd (a U.S. person, and Adam's son)** and **Carol**, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust assets must be distributed to **Carol**. Because it is possible that income may be accumulated in each year, and that the accumulated income ultimately may be distributed to **Boyd**, a U.S. person, **FT** is treated as having a U.S. beneficiary during each of **Adam's** tax years from 2001 through 2011. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Note: There are many examples in the regulations under 1.679-1 through 1.679-6 to illustrate when a trust is treated as having a U.S. beneficiary; that transfers to foreign trusts can be direct, indirect or constructive, and exceptions to the general rule. §7701(a)(31)(B).

Continued on next page

Instructor Notes

Please emphasize the differences between grantor and non-grantor trusts and how the taxpayers have to file the tax returns related to these trusts.

Reading Assignment

IRC §§ 641 – 685, and 871.

Non-Grantor Trust

A foreign trust that is found to be a legitimate separate entity (not a sham, alter ego, etc.), and is not disregarded under the grantor trust rules of IRC §§671-679, is referred to as a “**nongrantor foreign trust**.”

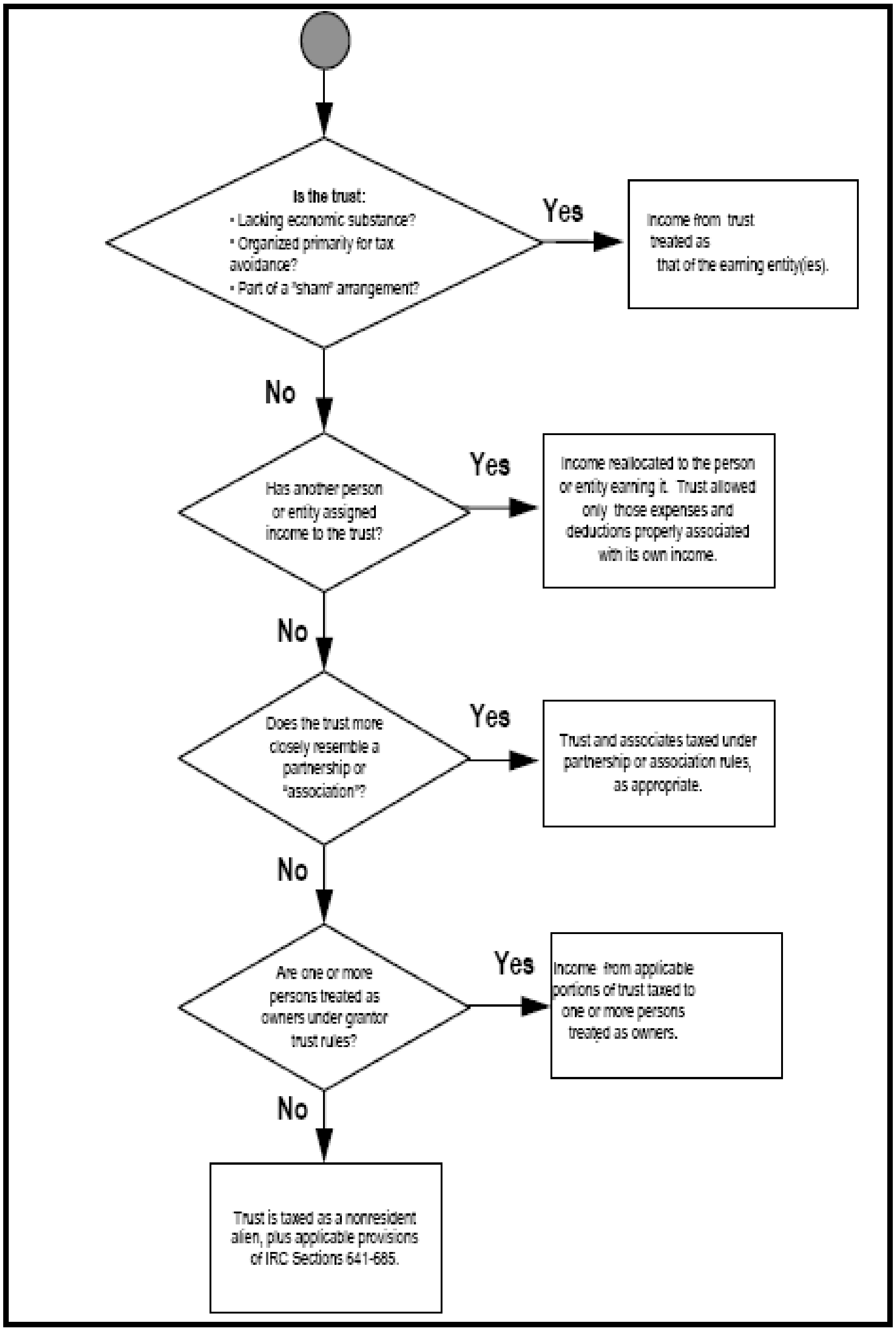
A nongrantor foreign trust is subject to the same general U.S. tax regime as a nonresident alien individual, with the addition of the special trust provisions of IRC §§641-685.

It is possible for a nongrantor foreign trust to defer U.S. federal income taxation. It would not be taxed by the U.S., except with respect to certain types of U.S. sourced income under IRC §871.

However, income distributions received from a nongrantor foreign trust are taxable to the U.S. person (beneficiary) who receives them.

It is beyond the scope of this course to make you an expert on the taxation of foreign nongrantor trusts and their beneficiaries. Our focus is on how to audit a foreign trust in which the U.S. owner continues to own and control the trust assets and income for income tax purposes.

Figure 4-1 Characterization of Trusts for Tax Purposes



Foreign Trust Filing Requirements

Form 3520

Form 3520 Annual Report to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.

Due Date of Return

Due on the date that the U.S. person's income tax return is due, including extensions.

- Separately filed with the Ogden Service Center.

Who Must File

Form 3520 reports events with potential tax consequences for the trust or other parties. This form must be filed by the following persons on the occurrence of any of the listed reportable events:

1. The **transferor** (or the executor of their estate) responsible for any reportable event, including:
   - Creation of a foreign trust by a U.S. person.
   - Direct or indirect transfer of money or property to a foreign trust by a U.S. person.
   - Death of a U.S. citizen or resident if the decedent was treated as an owner of a foreign trust under the grantor trust rules, or if any portion of a foreign trust was included in the decedent's gross estate.
   - A trust that was not a foreign trust becomes a foreign trust.
2. Any **U.S. person** who, for any part of the tax year, was **treated as an owner** of any part of the assets of a foreign trust under the grantor trust rules.
3. Any **U.S. person who**, during the tax year, **received a distribution** from a foreign trust, or who had an obligation outstanding to a foreign trust treated as a "qualified obligation."

Foreign Gifts

4. Any U.S. person who, during the tax year, received either:
   - More than $100,000 from a nonresident alien individual or foreign estate (or foreign person related to such nonresident alien individual or estate) treated as gifts or bequests, or
   - More than $14,165 for 2010 from foreign corporations or foreign partnerships (or foreign person related to such corporation or partnership) treated as gifts.

Continued on next page

Reading Assignment

IRC §§ 6048 and 6677.

Form 3520, (continued)

- A separate Form 3520 must be filed for transactions with each foreign trust.
- A joint Form 3520 may be filed if two transferors/grantors or two beneficiaries of the same trust file joint income tax returns.

Penalty for Failure to File Form 3520

IRC §6677 prescribes civil penalties for failure to report information required by IRC §6048. The IRC §6677 penalty applies if any notice or return required to be filed by IRC §6048:

- Is not filed on or before the due date, or
- Does not include all required information, or includes inaccurate information.

Form 3520 Due After 12/31/2009

For returns due after 12/31/2009, the initial penalty is the greater of $10,000 or:

- 35 percent of the gross reportable amount (gross value of property involved in any event, as of date of transfer, distribution, etc.) In addition, if the Failure To File continues for more than 90 days after notification by the Service an additional penalty will apply:
- $10,000 for each 30-day period (or fraction thereof) that the failure continues.
- The maximum penalty is limited to the gross reportable amount, if known.

Continued on next page

Form 3520 Due After 12/31/2009 (continued)

Example 19A-3

Jane Doe received a distribution from a foreign trust of $9,000. The initial penalty is the greater of $10,000 or 35% of the gross reportable amount, but the overall limitation of this subsection is the gross reportable amount, in this case $9,000 - so the penalty is limited to $9,000.

Example 19A-4

Jane Doe received a distribution from a foreign trust of $15,000. We give her 90 days notice, after which the continuation penalty applies. The initial penalty would be limited to the greater of $10,000 or 35% of $15,000; so a $10,000 initial penalty would apply. The continuation penalty would ultimately be limited to $5,000, so that the total of the initial penalty plus the continuation penalty doesn't exceed $15,000.

Form 3520 Due Prior to 1/1/2010

For returns due prior to 1/1/2010:

- Total penalties include the initial penalty of 35% of the gross reportable amount, plus the continuation penalty after 90 days notice, but the total of the initial and continuation penalties could not exceed the gross reportable amount.

  *This had the effect of limiting penalty assessments to $0 if the reportable amount was unknown.

The penalties for failure to file a complete and accurate Form 3520 can be very significant. The examples above used small distributions to illustrate the new law, but you may encounter transfers and/or distributions for $millions, for which the initial penalty would be 35%.

Continued on next page

Reporting Penalties for Failure to Report a Gift from Foreign Persons on Form 3520

Form 3520 is also used to report the receipt of gifts from foreign persons. Per IRC § 6039F, a U.S. person who receives a gift from a foreign person must file Form 3520 by the due date of their U.S tax return, including extensions.

IRC §6039F(c) imposes a penalty for Failure To File equal to 5 percent per month that the gift is not reported, to a maximum penalty of 25%. Additionally, the tax consequences of the receipt of such gift shall be determined by the Secretary.

Form 3520-A

A **foreign trust with** at least one **U.S. owner** must file Form 3520-A, entitled: Annual Information Return of Foreign Trust With a U.S. Owner. This form provides information about:

- The foreign trust
- Its U.S. beneficiaries, and
- Any U.S. person who is treated as an owner of any portion of the foreign trust .

Due Date of Return

Form 3520-A includes a balance sheet and income statement for the trust, as well as statements for each owner and beneficiary.

- Due to the Ogden Service Center by the 15th day of the 3rd month after the end of the trust's tax year.
- Filed separately from the U.S. individual’s income tax return.

Instructor Notes

Please emphasize the penalty for failure to file Form 3520-A and the defenses of reasonable cause.

Who Must File Form 3520-A

Under IRC §6048, each U.S. person treated as an owner of a foreign trust under §§671 through 679 is responsible for ensuring that the filing requirement is met. In addition, the U.S. owner is responsible for ensuring that the trust furnishes such information to each U.S. owner and each U.S. beneficiary of the trust.

Continued on next page

Penalty for Failure to File Form 3520-A

Per IRC §6677 a penalty generally applies if Form 3520-A is not timely filed or if the information is incomplete or incorrect.

For returns due after 12/31/2009, the initial penalty is the greater of $10,000 or:

- 5 percent of the gross reportable amount (gross value of trust assets at the close of the year treated as owned by the U.S. person). In addition, if the Failure To File continues for more than 90 days after notification by the Service an additional penalty will apply:
- $10,000 for each 30-day period (or fraction thereof) that the failure continues.
- The maximum penalty is limited to the gross reportable amount, if known.

For returns due prior to 1/1/2010:

- The total penalties include the initial penalty of 5% of the gross reportable amount, plus the continuation penalty after 90 days notice, but the total of the initial and continuation penalties could not exceed the gross reportable amount.

*This had the effect of limiting penalty assessments to $0 if the reportable amount was unknown.

Reasonable Cause for Failure to File

Ignorance of Filing Requirement: As a reasonable cause defense for failure to file Forms 3520, 3520-A, and other international information returns, many taxpayers will present the defense that they were unaware of the duty to file and therefore had reasonable cause for the failure to file, which should excuse the penalty. There is extensive case law rejecting this defense.

Continued on next page

Reasonable Cause for Failure to File (continued)

The essence of this defense is that the taxpayer didn't neglect a **known** duty and shouldn't be penalized for ignorance of the filing requirement, especially since these returns are unusual. It is not necessary to have willful neglect in order to lack reasonable cause. If a return is required under the statute and regulations, the mere uniformed belief that no return is due, no matter how genuine, is not reasonable cause. To have reasonable cause, the taxpayer must inquire of a tax professional, disclose all the relevant facts, and rely on the advice given. A few of the many cases supporting this are:

Case Law

Henningsen v. Commissioner, 243 F.2d 954, 958 (4th Cir. 1957)

Janpool v. Commissioner, 102 T.C. 499, 504-505 (1994)

N.Y. State Assn. Real Est. Bd. Group Ins. Fund v. Commissioner, 54 T.C. 1325, 1336 (1970)

Heman v. Commissioner, 32 T.C. 479, 490 (1959)

Coshocton Securities v. Commissioner, 26 T.C. 935, 939 - 940 (1956)

Some of these cases involve relatively obscure returns such as personal holding company returns (Coshocton Securities Co.), and domestic trust returns (Heman). The point of all these cases is that taxpayers are obligated to inform themselves of their various filing obligations, and that ignorance of the filing duty is not reasonable cause unless they consulted a professional tax advisor and were told they didn't need to file.

Example of Defense Ignorance v. Lack of Knowledge

The defense of ignorance of a filing requirement should be contrasted with the defense of lack of knowledge of facts giving rise to a filing requirement, which would be reasonable cause. An example of the latter would be a person who did not realize he is a U.S. citizen (e.g., a person who was born to a non-resident mother temporarily present in the U.S., but who was raised in another country). That person would be unaware of essential facts that would put him on notice that he should inquire about U.S. filing obligations.

Continued on next page

Reading Assignment

IRC §§ 6501(a), and 6501(c)(8).

Statute of Limitations

To Assess Penalties: The statute of limitations for assessment of the penalties under §§ 6677 (Forms 3520 and 3520-A for transactions with or ownership of foreign trusts), or 6039F(c) (Form 3520 for reportable foreign gifts) will run from the filing of the return, in accordance with IRC § 6501(a).

IRC § 6501(c)(8)

Extension of the normal statute to assess tax: <u>This is very important</u> - The statute of limitations for assessment of any income tax liability stemming from amounts reportable under IRC § 6048 (Forms 3520 and 3520-A) is extended until 3 years after the date on which the information is furnished to the Secretary.

How to Determine if Forms 3520 and 3520-A have been Filed

All Forms 3520 filed after 12/31/2000 are on Business Master File:

- MFT Code 68 (See IRM 20.1.9.13.1(7) for detailed instructions)

All Forms 3520-A filed after 12/31/2000 are on Business Master File:

- MFT Code 42 (See IRM 20.1.9.14.1(8) for detailed instructions)

Form 1040NR

Form 1040 U.S. Nonresident Alien Income Tax Return is filed by the fiduciary of a nongrantor foreign trust which has U.S. sourced income not covered by withholding. Form 1040NR is designed to deal with the differing treatments of various classes of income. A check box under the taxpayer identification number (TIN) allows the filer to indicate if the form is being filed for an estate or trust.

Continued on next page

Form 1040NR (continued)

The instructions for Form 1040NR contain the following statement: If you are filing Form 1040NR for a nonresident alien estate or trust, change the form to reflect the provisions of Subchapter J, Chapter 1, of the Internal Revenue Code, because a nongrantor foreign trust is subject to the same general U.S. tax regime as a nonresident alien individual, with the addition of the special trust provisions of IRC §§641-685.

It is due on April 15th.

The offshore structures/arrangements which include foreign trusts that you investigate will have U.S. owners who should be filing Form 3520-A, not Form 1040NR. Form 1040NR is mentioned here for your awareness only.

Foreign Trusts

Summary

Depending on the facts and circumstances, a foreign trust may be treated in one of several ways for income tax purposes:

- The trust may be disregarded because it is a “sham” arrangement, lacks economic substance, or has tax avoidance as its principal purpose, or
- The trust may be found to be a business entity more closely resembling a partnership, or an association taxable as a corporation, or
- The trust may meet the statutory definition of a “grantor trust,” in which case the trust is disregarded for tax purposes, and income is taxed directly to the grantor(s) or other person(s) treated as owner(s) of the trust, or
- The trust may be taxed directly as a nongrantor trust, or at the beneficiary level to the extent the income is considered distributed.

Exercise 1

Jack Doe, a U.S. citizen, creates the Jack Doe Trust, a foreign trust on May 30, 2005 and transfers real estate to it on this same date. The fair market value of the real estate on the date of transfer is $5 million with an adjusted basis of $3 million. Subsequent transfers are made as follows:

- $1 million on March 7, 2006,
- Real estate with a fair market value of $500,000 and an adjusted basis of $450,000 on August 20, 2006,
- Stock with a fair market value of $100,000 and an adjusted basis of $50,000 on December 24, 2006 and
- $700,000 on October 11, 2007

The value of trust corpus at year end is as follows:

$5.1 M – 2005
8.0 M – 2006
9.5 M – 2007

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Exercise 1 (continued)

No Forms 3520 or 3520A are filed for 2005 – 2007.

Compute the penalties under IRC §6677 for 2005 - 2007

Answer:

Foreign Corporations – International Business Companies

Foreign Corporation

Under IRC § 7701(a)(5), a "foreign corporation" means a corporation which is not "domestic", that is not created or organized in the United States. As a starting point for determining whether a foreign entity will fall under these rules we look to Treas. Reg. 301-7701-2 for the definition of business entity, corporation, and foreign/per se corporations.

IBC

Many of your audits of offshore structures/arrangements will include one or more **International Business Companies (IBCs)**. As you saw in Lesson 1, an IBC refers to a special type of corporation organized in an offshore secrecy jurisdiction that is afforded certain tax advantages and protection as to disclosure of its beneficial owner. Generally, IBC's are not allowed to conduct business in the jurisdiction where they are organized and cannot engage in business activity with its citizens or residents. Often, an IBC is used as a vehicle to hide beneficial ownership interest in bank accounts and assets.

PIC

A **Private Investment Company** (PIC) is a term used in the banking industry to refer to a corporation or other entity formed to hold the investment assets of a bank client. When formed offshore, PICs are generally IBCs and so the terms are analogous.

CFC

Any corporation organized outside the United States where U.S. shareholders own more than 50% of the voting stock or the value of all stock of the corporation is a **controlled foreign corporation (CFC)**. A U.S. shareholder is any U.S. person that owns or is considered as owning 10% or more of the total combined voting power of the foreign corporation's stock.

Subpart F Income

Rules regarding the taxation of income received by a CFC are complex and involve a determination of whether **"Subpart F" income** is present. If it is, then to the extent of the earnings and profits of the corporation, that income is taxable each year to the 10% or more U.S. shareholders.

Continued on next page

Subpart F Income, (continued)

Congress adopted the subpart F rules as a way to discourage U.S. persons from using foreign corporations to defer U.S. taxes on income that is considered "easily movable" from one jurisdiction to another and for which there was really no or limited business or economic reason to have the foreign corporation incorporated in that foreign jurisdiction. For example, without the subpart F income rules a U.S. person could create and incorporate a foreign corporation in a low or no tax foreign jurisdiction and use the capital of that foreign corporation to invest in assets, such as foreign debt obligations, stock of foreign corporations, etc., that only produce foreign source income.

A foreign corporation is not subject to U.S. tax on income that is neither from U.S. sources nor effectively connected with a U.S. business. This exemption is appropriate for foreign corporations owned by foreign persons, but is U.S. tax avoidance when the foreign corporation is owned by U.S. persons.

Normally, when a U.S. person is a shareholder of a U.S. corporation, the shareholder is taxed only on dividends and gains on sales of stock, not on the corporation's undistributed earnings, but because the corporation is taxed on its worldwide income, none of the income beneficially owned by the shareholder escapes current U.S. taxation. In contrast, if a U.S. person is a shareholder of a foreign corporation whose property and business activities are wholly located outside the United States, the corporation pays no U.S. tax, and under the normal rules, the shareholder pays no U.S. tax on the corporation's earnings until they are distributed as dividends. By putting the foreign operations or investments in a foreign corporation, the U.S. person was able to avoid current taxation of income beneficially owned by the U.S. person as well as to convert ordinary income to capitall gains (by letting the profits build up in the foreign corporation and then sell the appreciated stock at a gain). This is the type of activity that Congress wanted to address by adopting the subpart F income rules whereby under IRC §§ 951-964 a U.S. shareholder of a CFC is taxed directly on portions of the earnings of the foreign corporation, even if the foreign corporation does not distribute them.

Continued on next page

Subpart F Income, (continued)

Subpart F Income is a collection of types of income that Congress found subject to no or low tax manipulation. The most common types of subpart F income you may encounter includes passive investment income (Foreign Personal Holding Company Income), income from sales of goods purchased from or sold to a related person and the sale or purchase is outside the country in which the CFC is incorporated (Foreign Base Company Sales Income), income from services performed for or on behalf of a related person where the services are performed outside the country in which the CFC is incorporated (Foreign Base Company Services Income) and income from insuring risks outside the CFC's country of incorporation (Insurance Income).

Instructor Notes

If possible, please show the Participants real examples of Forms 5471, 5472, 926, and 8865.

Subpart F Income, (continued)

In addition, a CFC earnings, other than subpart F income are taxed directly to the shareholder if they are invested in assets located in the United States. Also, if a CFC accumulates earnings that are not taxed to shareholders as subpart F income or as earnings invested in the U.S. property, a U.S. shareholder is usually taxed on its share of the accumulated earnings as a dividend when it sells its stock.

The purpose of subpart F income to deny deferral of U.S. taxation never requires that U.S. shareholders of a CFC be taxed on amounts exceeding the dividends they would have received if all income had been distributed currently, and earnings and profits are the measure of a dividend.

Form 5471

Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations: U.S. persons who are shareholders, officers or directors of a foreign corporation (or international business company) may be required to file this form. Form 5471 is not limited to the shareholders of a "controlled foreign corporation", even though the US shareholders of a CFC are the most likely to be required to file.

Continued on next page

Form 5471 (continued)

The percentage ownership tests can be very involved because of the attribution of ownership rules and constructive ownership rules. Shares of a foreign corporation owned by certain family members (except for nonresident alien family members) and shares owned by corporations or partnerships in which the US person is a partner or shareholder must be counted based on the person's ownership interest in the intermediate entity.

The form is designed to serve multiple purposes, and there are four categories of persons that may be required to file it.

From an examination perspective, Form 5471 provides us with the information we need to determine if there may be U.S. taxation of the income of the foreign corporation, including whether it is a CFC, and whether the Subpart F rules apply to U.S. shareholders.

Form 5471 is similar to the information return for a partnership, an S corporation or a trust. Unlike a regular C corporation, the income of a foreign corporation may be either currently taxed to the shareholders under the subpart F income rules or tax deferred until there is a distribution or a liquidation. If the foreign corporation has U.S. source income, that income will be subject to U.S. tax the same as a domestic corporation.

IRC §6501(c)(8) Extended Statute

Just as for failure to file substantially complete Forms 3520 and 3520-A, under **IRC §6501(c)(8)** the statute of limitations for assessment of any income tax liability stemming from amounts reportable under IRC §6038 or §6046 is extended until 3 years after the date on which the information is furnished to the Secretary. <u>In most abusive offshore arrangements this form is not filed so we generally have an extended statute</u>.

This form is used to satisfy reporting requirements of IRC §§6038, 6035 (returns of officers, directors, and shareholders of foreign personal holding companies), and 6046 (reporting of organization or reorganization of foreign corporations and acquisitions of their stock). As mentioned previously, the FPHC rules of §552 and the filing requirements under §6035 were repealed for years after 12/31/04.

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Who must file

Category 1 - deleted
Category 2 - US citizen or resident who is an officer or director of a foreign corporation in which a US person acquires stock and meets the 10% ownership requirements.
Category 3 - a US person who acquires, or disposes of, stock in a foreign corporation and meets the 10% stock requirement rules.
Category 4 - a US person who had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.

- For this purpose, “control” is defined as a U.S. person who owns **more than** 50% of the foreign corporation by vote OR value.

Category 5 - a U.S. shareholder who owns stock in a CFC for an uninterrupted period of more than 30 days during the annual accounting period of the foreign corporation and who owned that stock on the last day of that year.

- For this purpose, a U.S. Shareholder is defined as a U.S. person that owns 10%, or more, of the voting stock of the CFC.

Reading Assignment

IRC §§ 6501(a), and 6501(c)(8).

10% Ownership Requirement

For purposes of Category 2 and 3 filers, the 10% stock ownership requirement is met if a person:

- Acquires 10% or more of the stock in one transaction, or
- Acquires stock that, when added to the stock previously owned, equals 10% or more of the total outstanding stock.

When to file Form 5471

Form 5471 is attached to and due:

- With the U.S. person’s income tax return
- On or before the due date of the return, including extensions.

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Monetary Penalties for failure to furnish information on Form 5471

Penalties for Failure To File Form 5471 apply when:

- Form is not filed, or
- Form is not filed by the due date (late filed), or
- Form is “substantially incomplete”

The penalty per **IRC §6038(b)** for failure to furnish all the required information timely on a Form 5471, applies to **Category 4 and 5 filers**, and is:

- $10,000 per Form 5471 that the U.S. shareholder fails to file.

If the information is not filed within 90 days after notice of the failure to the U.S. shareholder, additional penalties apply:

- $10,000 per failure to file for each 30-day period, or fraction thereof, during which the failure continues.
- The maximum additional penalty for each Form 5471 is $50,000.

Note: The maximum total penalty for each Failure To File Form 5471 is $60,000 ($10,000 initial penalty and the $50,000 continuation penalty).

IRC §6679 describes the civil penalty for any U.S. person who is required to furnish information under IRC §6046 - applicable to **Category 2 or 3 filers - Form 5471 Schedule O**, who fails to timely file Form 5471 or files an incomplete Form 5471:

- The penalty for Failure To File information required by IRC §6046 is $10,000.

In addition, if the information required to be furnished is not filed within 90 days after notice of the failure, an additional penalty of

- $10,000 (per foreign corporation) for each 30-day period, or fraction thereof, during which the failure continues will apply.
- This additional penalty for each failure is limited to a maximum of $50,000.

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Monetary Penalties for failure to furnish information on Form 5471 (continued)

A **Category 4 or 5 U.S. shareholder** who fails to furnish a timely, completed, Form 5471 could find his or her foreign tax credit (FTC) reduced as a result of this failure. This penalty can be asserted in addition to the monetary penalty, but the FTC penalty is reduced by the amount of the monetary penalty. This is beyond the scope of this lesson, and this penalty is rarely asserted. See IRC §6038(c).

Exercise 2

On October 15, 2005, Jill Doe, a U.S. citizen, transferred in an IRC § 351 transaction $100,000 cash to a foreign corporation in exchange for all its issued stock, so that Jill was the sole owner of this foreign corporation. The foreign corporation does not engage in a trade or business within the United States. Jill files no information returns for 2005.

Is Jill Doe required to file Form 5471? If yes, what would be the due date. In addition, compute the initial and continuation penalty, assuming you sent notice of the failure to file on 6/30/2008, and the taxpayer files the form on 9/20/2008. How about if the form is filed on 11/5/2008?

Note: Whether Jill needs to file Form 926 will be illustrated in that section of this Lesson 4.

Answer:

Form 5472

Form 5472

Form 5472 - Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.

Introduction

Under IRC §6038A, a **U.S. corporation with a foreign shareholder that owns directly or indirectly at least 25% of the voting stock or value of all the stock of the U.S. corporation** -- must file this form **in any year when the US corporation has a reportable transaction with a foreign or domestic related party.**

Under IRC § 6038C a **foreign corporation engaged in a trade or business within the United States at any time during a taxable year** must file a Form 5472.

A separate Form 5472 must be filed for each foreign or domestic related party with which the reporting corporation had a reportable transaction during the tax year.

Generally, a **reportable transaction** is any exchange of money or property with the foreign shareholder or foreign related party except for the payment of dividends.

The form requires the disclosure of the foreign shareholders' name, address and country of citizenship, organization or incorporation as well as the nature and amount of the reportable transaction with each foreign shareholder. It is only required where any one foreign person owns 25% or more of the U.S. corporation.

Who Must File

Form 5472 is filed by:

- A **reporting corporation**
- With **reportable transactions**
- With **related parties**

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Reporting Corporation

To be subject to the reporting requirements of IRC § 6038A, the entity must be a "reporting corporation":

- A U.S. corporation with at least one direct or indirect 25% foreign shareholder at any time during the year, OR
- A foreign corporation engaged in a trade or business within the United States.

Reportable Transaction

- Any type of transaction listed on Form 5472, Part IV (e.g., sales, rents, etc.) for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the reporting corporation's tax year, OR
- Any transaction or group of transactions listed in Part IV, if:
  - Any part of the consideration paid or received was not monetary consideration **or**
  - If less than full consideration was paid or received Items such as dividends and contributions to capital are **not** reportable transactions.

Coordination with IRC Section 6038

Form 5472 is not required with respect to a related foreign corporation if the reportable transactions are already reported on Form 5471 by the U.S. person that controls the foreign related corporation.

However, reporting a transaction on a Form 5472 does **NOT** relieve the requirement for Form 5471.

When to file Form 5472

Form 5472 must be filed:

- With the reporting corporation's income tax return
- By the due date (including extensions) of that return; however, if the reporting corporation's income tax return is not timely filed, Form 5472 (with a duplicate to Ogden) must be filed timely at the Campus where the income tax return is due.

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Dual Filing Requirement

In addition, the U.S. corporation **MUST** file a duplicate copy of **ALL** Forms 5472 with the Ogden. This requirement is found in the Instructions for Form 5472. However, a Form 5472 that is timely filed electronically (as an attachment to a timely filed income tax return) satisfies the duplicate filing requirement.

A separate Form 5472 must be filed for each foreign or domestic related party with which the reporting corporation had a reportable transaction during the tax year.

Monetary Penalty for failure to furnish information on Form 5472

Penalties for Failure To File Form 5472 apply when:

- Form is not filed
- Form is not filed by the due date (late filed)
- Form is “substantially incomplete”

Failure to comply with the reporting requirements under §6038A, for Form 5472 will incur a penalty:

- $10,000 for each failure to file

In addition, if the failure continues for more than 90 days after notification by the Service, an additional penalty will apply:

- $10,000 for each 30 day period (or fraction thereof) during which the failure continues.
- **NO** maximum limit to this continuation penalty
- Penalty will be asserted until failure is cured

The penalty also applies for failure to maintain records as required by Regulations section 1.6038A-3. This is beyond the scope of this lesson, but is something to be aware of.

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Noncompliance Penalty

In addition to the monetary penalty for failure to file Form 5472, section 6038A(e) also provides a "noncompliance penalty" for:

- Failure to respond to an administrative summons, or
- Failure to provide an "authorization of agent"

Under this penalty:

- The amount of any deduction allowed:
  - For any amount paid or incurred by the reporting corporation to the related party in connection with such transaction, and
  - The cost to the reporting corporation of any property acquired in such transaction from the related party

may be:

- determined by the Service in its sole discretion
- from its own knowledge or from such information that it may obtain through testimony or otherwise.

Therefore, this noncompliance penalty, which is in the form of an adjustment to the reporting corporation's deductions, becomes part of the tax deficiency with respect to the income tax return and is not dependent upon any reporting requirement.

Form 926

Form 926

Form 926 Return by a U.S. Transferor of Property to a Foreign Corporation: A U.S. person who makes a transfer of property to a foreign corporation may be required to file this form, as set forth in IRC § 6038B(a)(1)(A) or 367(d) or (e). Generally, the form is required for transfers of property in exchange for stock in the foreign corporation, but there are other code sections that may require the filing of this form.

The form requires the name, address and tax ID of the person or entity making the transfer, the name and tax ID of the controlling shareholder if the transferor went out of existence pursuant to the transfer, and a description of the property transferred to the foreign corporation. Information required to be reported includes descriptions of assets transferred (such as type and basis) and a description of the transaction that was used to transfer the assets.

By requiring this information be included on the form, we are able to assess a taxpayer's compliance with Sec. 367, which generally requires the current recognition of gain on transfers of appreciated property (whether personal or intangible) to a foreign corporation unless an exception applies.

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Transfers to a Foreign Corporation

Per IRC Section 6038B, a U.S. citizen or resident, a domestic corporation, or a domestic estate or trust must file Form 926 to report:

- Transfer of **property** to a foreign ***corporation*** in an exchange described in IRC sections 6038B(a)(1)(A), section 367(d) or (e).
    - Except for stock or securities which are subject to the special reporting rules of Treas. Reg. § 1.6038B-1(b)(2)
    - A transfer is described in IRC section 6038B(a)(1)(A) as any transfer of property to a foreign corporation as described in IRC section 332, 351, 354, 355, 356, or 361.
        - Such transfers are reportable even if such property is not appreciated property.
- A transfer of **cash** to a foreign ***corporation*** if:
    - Immediately after the transfer the US transferor holds directly, indirectly, or by attribution at least 10 percent of the total voting power or the total value of the foreign corporation, or
    - The amount of cash transferred by such person or any related person to the foreign corporation during the 12-month period ending on the date of transfer exceeds $100,000.

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Where and When to File

Form 926 is filed as an attachment to the transferor's income tax return for the taxable year that includes the date of the transfer. The form must be filed by the due date of the transferor's income tax return including extensions.

Failure to comply with the reporting requirements under §6038B, for transfers to a foreign corporation will incur a penalty under section 6038B(c)(1):

- **10 percent of the fair market value** of the transferred property at the time of the exchange, **not to exceed $100,000**, unless the failure was due to intentional disregard
- **Intentional disregard** occurs when the taxpayer knew of the rule or regulation, but chose to ignore it. In this case, the monetary penalty will NOT be limited to $100,000.

It is considered a failure to comply with the requirements of section 6038B if the taxpayer:

- Fails to report at the proper time and in the proper manner any material information required to be reported under Treas. Reg. § 1.6038B-1 or
- Provides false or inaccurate information in purported compliance with the requirements of this section.

Therefore, if a timely filed Form 926 contains inaccurate information, the penalty will still apply.

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Where and When to File (continued)

Exercise 3

As we saw in Exercise 2, on October 15, 2005, Jill Doe, a U.S. citizen, transferred in an IRC § 351 transaction $100,000 cash to a foreign corporation in exchange for all its issued stock, so that Jill was the sole owner of this foreign corporation. The foreign corporation does not engage in a trade or business within the United States. Jill files no information returns for 2005. As we discussed, Jill is required to file F5471.

Is Jill Doe required to file Form 906? If yes, what would be the due date and the amount of the penalty?

Answer:

Foreign Partnerships

Form 8865

Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships.

Introduction

A partnership formed in a foreign country that is controlled by U.S. partners requires the filing of Form 8865. Control means that five or fewer U.S. persons who each own a 10% or greater interest in the partnership also own (in the aggregate) more than 50% of the partnership interests.

A US person who is a partner in a foreign partnership (or an entity electing to be taxed as a partnership) may be required to file Form 8865 to report the income and financial position of the partnership and to report certain transactions between the partner and the partnership (See categories of filers below). The form is required to be filed with the partner's tax return.

Form 8865 requires substantially the same information as a U.S. partnership Form 1065 and much of the same information that is required by a foreign corporation Form 5471. It requires a statement of the net profits of the partnership, details of any capital gains, a summary of the K-1 forms for the partners, a balance sheet, a reconciliation of the partner's capital accounts, and information about transactions between the controlled foreign partnership, its partners and any related entities.

The form also provides for the disclosure of the name, address and taxpayer I.D. of the partners, information about transfers of property to the partnership and any changes in the ownership interest of any partner.

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Who must file

Category 1 - a U.S. person who controls a foreign partnership at any time during the year.

- For this purpose, “control” is defined as ownership of more than 50% interest in the partnership

Category 2 - a U.S. person who owned 10% or greater of a partnership controlled by U.S. persons.

- However, if the foreign partnership had a Category 1 filer, no person will be considered a Category 2 filer.

Category 3 - a U.S. person who contributed property to the foreign partnership in exchange for an interest in that partnership if that person:

- Owned at least 10% of the partnership interest immediately after the contribution, OR
- The value of the property exceeds $100,000
  - this includes the values of this transfer and any other transfers within a 12 month period.

Category 4 - a U.S. person who had a reportable event per IRC Section 6046A:

- Acquisition
- Disposition
- Change in proportional interest.

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Form 8865 Schedule O

IRC §6038B requires a U.S. person who transfers property to a foreign partnership as a contribution in exchange for an interest in the partnership to report that transfer (**a Category 3 filer**). However, the U.S. person who contributed this property to the foreign partnership would only have to report the transfer under §6038B if:

- Immediately after the contribution the person owned at least a 10 percent interest in the foreign partnership OR
- The value of the property contributed (when added to the value of any other property contributed to the partnership by such person, or any related person, during the 12-month period ending on the date of transfer) exceeds $100,000.

In addition, if a foreign partnership disposes of appreciated property previously contributed by a U.S. person who was required to report that contribution under IRC §6038B, then the U.S. person must file a Form 8865 to report the disposition of that property if the U.S. person remains a direct or indirect partner in that foreign partnership at the time of the partnership's disposition of the property.

Form 8865 Schedule P

IRC §6046A requires a U.S. person who had an acquisition of or a disposition of an interest in a foreign partnership, or whose proportional interest in a foreign partnership changed substantially to file Form 8865 (**a Category 4 filer**).

Under §6046A, a United States person must file Form 8865 if:

- They didn't have previously, but now acquire a 10% or more interest in the foreign partnership, **OR**
- The value of the property contributed (when added to the value of any other property contributed to the partnership by such person, or any related person, during the 12-month period ending on the date of transfer) exceeds $100,000.

In addition, if a foreign partnership disposes of appreciated property previously contributed by a U.S. person who was required to report that contribution under IRC §6038B, then the U.S. person must file a Form 8865 to report the disposition of that property if the U.S. person remains a direct or indirect partner in that foreign partnership at the time of the partnership's disposition of the property.

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Form 8865 Schedule P (continued)

IRC §6046A requires a U.S. person who had an acquisition of or a disposition of an interest in a foreign partnership, or whose proportional interest in a foreign partnership changed substantially to file Form 8865 (a Category 4 filer).

Under §6046A, a United States person must file Form 8865 if:

- They didn't have previously, but now acquire a 10% or more interest in the foreign partnership, **OR**
- As a result of the acquisition the U.S. person's direct partnership interest has increased by at least a 10 percent interest (e.g., from 11% to 21%) as compared to their direct partnership interest when the U.S. person last had a reportable event under IRC §6046A, **OR**
- As a result of a disposition the U.S. person's direct partnership interest has decreased by at least a 10 percent interest (e.g., from 21% to 11%) since their last reportable event under IRC §6046A, **OR**
- They dispose of enough of a partnership interest to bring them below the 10% ownership level.

When to File

Form 8865 must be filed:

- With the U.S. person's income tax return
- On or before the due date of the return, including extensions

If the U.S. person does not have to file an income tax return, they must file Form 8865 separately at the time and place they would have been required to file an income tax return.

The information that must be furnished under §6038 is for the tax year of the partnership ending with or within the U.S. person's taxable year.

A transfer reported under §6038B must be reported on Form 8865 attached to the transferor's timely filed (including extensions) income tax return for the tax year that includes the date of the transfer.

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Monetary Penalties for failure to furnish information on Form 8865

Penalties for Failure To File Form 8865 apply when:

- Form is not filed, or
- Form is not filed by the due date (late filed), or
- Form is "substantially incomplete"

The civil penalty for Failure To File per IRC Section 6038(b) is:

- $10,000 for each annual accounting period of each Form 8865 required to be filed.

If the information is not filed within 90 days after notification by the Service, an additional penalty will apply:

- $10,000 (per Form 8865) for each 30-day period, or fraction thereof, during which the failure continues.
- The maximum additional penalty for each failure is $50,000.

Note: The maximum total penalty for each Failure To File Form 8865 is $60,000 ($10,000 initial penalty and the $50,000 continuation penalty).

In addition, the U.S. person who fails to furnish a timely, completed, and accurate Form 8865 could find their foreign tax credit reduced as a result of this failure. This penalty can be asserted in addition to the monetary penalty, but the FTC penalty is reduced by the amount of the monetary penalty. This is beyond the scope of this lesson, and this penalty is rarely asserted. See §6038(c).

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Penalty for Failure to File Form 8865, Schedule O

Failure to comply with the reporting requirements under §6038B, for transfers to a foreign partnership will incur a penalty under section 6038B(c)(1) in the amount of:

- 10 percent of the fair market value of the transferred property at the time of the exchange.
- Not to exceed $100,000
- UNLESS the failure was due to intentional disregard.

Intentional disregard occurs when the taxpayer knew of the rule or regulation, but chose to ignore it. In this case, the monetary penalty will NOT be limited to $100,000.

In addition, the US person who failed to file the form must recognize gain as if the contributed property had been sold for fair market value on the date of the transfer.

Penalties for Failure to Furnish Information on Form 8865 Schedule P

Failure to comply with the reporting requirements under §6046A, for Acquisitions, Dispositions or Change In Proportional Interest in a foreign Partnership, will incur a penalty per section 6679:

- $10,000 for each annual accounting period of each Form 8865, Schedule P required to be filed.

In addition, if the failure continues for more than 90 days after notification by the Service, an additional civil penalty applies:

- $10,000 will apply for each 30-day period (or fraction thereof) during which the failure continues
- The additional penalty shall not exceed $50,000

Foreign Account Tax Compliance Act (FATCA)

Instructor Notes

Please have the Participants pay attention on this new concept and go over Form 8938, Statement of Foreign Financial Assets and its penalties.

Introduction

The Hiring Incentives to Restore Employment Act (H.I.R.E.) includes foreign financial account reporting provisions in part taken from the previously introduced FATCA (Foreign Account Tax Compliance Act). **<u>Self-reporting by holders of certain foreign assets</u>**: One of these reporting provisions requires holders of certain foreign assets to disclose their ownership of, and information about, those assets on their income tax returns.

Form 8938

A complete and accurate **Form 8938, *Statement of Foreign Financial Assets,*** attached to a timely filed tax return fulfills the reporting requirements. This reporting, effective for tax years beginning after March 18, 2010, falls under new Internal Revenue Code section 6038D and is aimed at individuals , where

- The aggregate value of all the assets exceeds $50,000 (or such higher dollar amount as the Secretary may prescribe). "Foreign financial assets" include any depository, custodial or other financial account maintained by a foreign financial institution and to the extent not held in an account maintained by a financial institution:
  - Any stock or security issued by a person other than a U.S. person
  - Any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. person
  - Any interest in a foreign entity
- **Related Penalties** include:
  - **$10,000 penalty** - Code Section 6038D(d)(1). This penalty may be increased if the taxpayer is notified about the failure and does not respond within 90 days after the day the notice is mailed. The increase is $10,000 for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period. The penalty cannot exceed $50,000. I.R.C. § 6038D(d)(2). The penalty is subject to abatement provided the failure is due to reasonable cause and not willful neglect. I.R.C. §6038D(g).

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Form 8938 (continued)

- **40-percent accuracy-related penalty** - Code Sections 6662(b)(7) and (j). For underpayment of tax that is attributable to an "undisclosed foreign financial asset understatement." A "foreign financial asset understatement" for any tax year is the portion of the understatement for the year that is attributable to any transaction involving an undisclosed foreign financial asset that should have been disclosed under information reporting sections listed in Section 6662(j)(2), on which list Section 6038D is included.

Statute Considerations

- **Statute Considerations** include:
  - Section 6501(c)(8), was amended to include Section 6038D, having the effect of preventing the general three-year period for assessment from beginning to run for items on the return relating to the failure provided the taxpayer acted with reasonable cause and not with willful neglect. **Note: If the taxpayer did act with willful neglect, the extended statute applies to the entire related return, not just as related to the items that should have been reported on the foreign information return.**
  - The substantial omission provision extending the Statute of Limitations from three years to six years, Section 6501(e), was amended to provide that the six-year period applies if there is an omission of gross income in excess of $5,000 and the omitted gross income is attributable to a foreign financial asset with respect to which:
    - Information reporting is required under Code Section 6038D or
    - Would be required if Code Section 6038D were applied without regard to the $50,000 aggregate asset value threshold amount and any other exceptions provided by regulations permitted under Section 6038D(h)(1) involving duplicative disclosure of assets.

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Reading Assignment

IRC §§ 1471 – 1474.

Third Party Reporters

- **<u>Third party reporters</u>:** Provides for reporting by foreign financial institutions with respect to their U.S. account holders and reporting by other foreign entities on their beneficial substantial U.S. owners.
    - The penalty for not participating is a 30% withholding tax on “withholdable payments” made to noncompliant foreign financial institutions (“Nonparticipating FFIs”) and non-financial foreign entity payees.
    - The withholding provisions of the Act are generally effective for payments made after December 31, 2012.

To avoid withholding tax, a “foreign financial institution” must enter into an information reporting agreement with the Treasury Department that will require the foreign financial institution to obtain and report certain information about its “United States accounts.” Those requirements are in the Internal Revenue Code under IRC section 1471-1474 (Taxes To Enforce Reporting On Certain Foreign Accounts).

International Penalty Assessment and Case File Procedures

Reading Assignment

- IRC §§ 6038(b), 6038A(d), 6038B(c), 6038C(c), 6039F(c), 6046, 6046A, 6048, 6501, 6677, and 6679.
- IRM 20.1.9. as of April 22, 2011.

Penalty Handbook

IRM 20.1.9, ***Penalty Handbook, International Penalties.***
The Penalty Handbook covers all of the international penalties in this lesson, including Penalty Assessment and Case File Procedures, and was just revised as of 4/22/2011. It covers each of the forms, in the following sequence:

1. Reporting/Filing Requirements
2. Penalty Letters/Notice Letters/Notices information
3. Penalty Assertion information
4. Penalty Computation information
5. Reasonable Cause information.

International Penalty Statutes of Limitation

The following is a summary of the statute of limitation rules in regards to foreign information returns. A more detailed analysis is provided in IRM 20.1.9

IRC §§ 6038(b), 6038A(d), 6038B(c), 6038C(c), 6039F(c), 6677 and 6679 penalties address both failure to file and the adequacy of a filed return. A filed return with material errors or omissions may be subject to the penalty.

Penalties that are subject to the Statute of Limitations:

- 6677 - Regarding U.S. ownership of or transactions with a Foreign Trust
- 6679 - Regarding Foreign Corporations and Foreign Partnerships

The statute of limitations for assessment of the penalties under §§ 6677, 6679 and 6039F(c) will run from the filing of the return, in accordance with IRC §6501(a).

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International Penalty Statutes of Limitation (continued)

Penalties that are NOT subject to the Statute of Limitations and are not contained in Chapter 68 of the Code:

- 6038(b)
- 6038A(d)
- 6038B(c)
- 6038C(c)

IRC §6501(c)(8) applies to IRC Sections / Forms:

- 6038 - Form 5471/Form 8865
- 6038A - Form 5472
- 6038B - Form 926 / Form 8865 Schedule O
- 6038D - Form 8938
- 6046 - Form 5471
- 6046A - Form 8865 Schedule P
- 6048 - Form 3520 or Form 3520-A

Under IRC §6501(c)(8), the period for assessing any tax due on certain unreported items is extended to three years from the date after the filing of these information returns.

Penalty Assessment and Case File Procedures are covered in **IRM 20.1.9.2**. Procedures may be updated, or unique to a particular project or initiative, so state of the procedures will be made available during each class, or as part of project/initiative guidance. In general:

1. **Requirement to File**: You must first establish the requirement to File.
2. **Fact of Filing**: You must determine that the information return wasn't filed, or wasn't timely filed.
3. **Referral:** Domestic examiners must make a referral on the Specialist Referral System for international assistance.
   a. Domestic examiners have been delegated the authority to issue penalty letters when referrals are not accepted, and to make all other penalty determinations.

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International Penalty Statutes of Limitation (continued)

4. **Penalty Case Control:** After you determine a penalty applies you will request approval for a penalty investigation from your manager, establish penalty case controls on ERCS (not AIMS), and create a penalty case file.
   a. Use Form 5345-D, *Examination Request-ERCS*, to establish a penalty case on ERCS. The case will show up on your Form 4502 with the TIN of the U.S. Person, MFT of P9 and the tax year. Charge time to this case as you would to any other case.
   b. The penalty case file is a separate case file from the income tax case files and includes:
      i. Form 8278 *Assessment and Abatement of Miscellaneous Civil Penalties*, and
      ii. Form 886-A (to explain what penalty is being assessed and how calculated).

Foreign Bank Account Reports (FBAR)

Instructor Notes

Please explain the procedures to this important FBAR form by having the Participants skim through the IRM sections 4.26.16 and 4.26.17.

Treasury Form 90-22.1 (FBAR)

In April 2003, the IRS was delegated civil enforcement authority for the FBAR.

- **IRM 4.26.16** covers FBAR law.
- **IRM 4.26.17** covers FBAR procedures.
- **New Regulations**: On February 24, 2011, the Treasury Department published final regulations amending the FBAR regulations. These regulations will be effective on March 28, 2011, and apply to FBARs required to be filed with respect to foreign financial accounts maintained in calendar year **2010** and for FBARs required to be filed with respect to all subsequent calendar years. The March 2011 Revision of **TD F 90-22.1, Report Of Foreign Bank and Financial Accounts (FBAR)** is now available and incorporates the new regulations, and is quite clear about who is required to file, exceptions, how, when and where.

Who is Required to File

TD F 90-22.1, Report Of Foreign Bank and Financial Accounts (FBAR), is required to be filed by each **United States person** who:

- has a **financial interest** in,
- **or signature authority, or other authority** over
- **a bank, securities, or other financial accounts in a foreign country,**

if the aggregate value of these financial accounts exceed $10,000 at any time during the calendar year.

A United States person has a **financial interest** in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others, including non-United States persons.

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Who is Required to File (continued)

If an account is maintained in the name of two persons jointly, or if several persons each own a partial interest in an account, each of those United States persons has a financial interest in that account.

- There are stated exceptions for years beginning with 2010 that apply to the following (for a complete list see the regulations or form instructions)
  - Certain accounts jointly owned by spouses
  - Trust beneficiaries (where a trust, trustee, or U.S. agent of the trust is (1) a U.S. person and (2) files an FBAR disclosing the trust's foreign financial accounts.

In addition, a United States person has a **financial interest** in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is:

- A person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person;
- A corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock;
- A partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income); **OR**
- A trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.

A person has **signature authority** over an account if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained.

Other authority exists in a person who can exercise comparable power over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means.

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Due Date of TD F 90-22.1 (FBAR)

The FBAR must be filed on or before June 30 for foreign financial accounts aggregating more than $10,000 in the previous calendar year; per 31 C.F.R. § 103.27(c), with:

Department of the Treasury
Post Office Box 32621
Detroit, MI 48232-0621

Penalties for Failure to File TD F 90-22.1 (FBAR)

The IRS has been delegated authority to assess Title 31 FBAR civil penalties. The IRM in 4.26.16 is very well written in regards to penalty administration, and what follows is a concise summary.

Degree of Fault

The degree of fault is key in determining the applicable FBAR penalty.

Generally, there are two types of FBAR penalties which apply to individuals:

- Willful and
- Non-willful

Willful Violation

Willful Violation - look to the IRM:4.26.16.4.5.3

The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. Willfulness is shown by the person's **knowledge of the reporting requirements** and the person's conscious choice not to comply with the requirements. In the FBAR situation, the only thing that a person need know is that he has a reporting requirement. If a person has that knowledge, the only **intent** needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR.

We will seldom, if ever, have a recording or statement of a taxpayer that they knew about the filing requirement and made a conscious choice not to file. What then? As stated in the IRM: Under the concept of "**willful blindness**", willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements.

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Willful Violation (continued)

Failure to learn of the filing requirements coupled with other factors, such as the efforts taken to conceal the existence of the accounts and the amounts involved may lead to a conclusion that the violation was due to willful blindness.

Examples of **willful behavior/factors** include that many taxpayers go to great lengths and expense to hide these offshore accounts for income and estate tax purposes, and to hide them from creditors including the IRS - that was the purpose for establishing the account(s). Many took affirmative steps to hide the account, such as having the tax haven bank treat the account as undisclosed (even executing "hold mail" agreements). We know they didn't check they owned/controlled foreign accounts on Forms 1040 Sch. B, didn't disclose the account or related income to their preparer, may have disclosed some accounts but not the ones in tax havens with large balances and related income, may have filed previously but stopped, and so it can be very reasonable for IRS to infer the failure to report the income was willful, and the failure to file the FBARs was willful.

We know that if they had disclosed the accounts to their preparer; the preparer, and/or tax software used to prepare returns would have highlighted their responsibility to report income from domestic and foreign sources, and file the FBARs.

Non-willful Violation

Non-willful Violation - look to the IRM:4.26.16.4.4, but it applies to a taxpayer who was negligent but doesn't rise to the level of willful. Taxpayers are obligated to inform themselves of their filing obligations, and that ignorance of the filing duty is not reasonable cause unless they consulted a professional tax advisor and were told they didn't need to file.

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Reasonable Cause

Taxpayers will present the defense that they were unaware of the duty to file and therefore had reasonable cause for the failure to file, which should excuse the penalty.

The essence of this defense is that the taxpayer didn't neglect a known duty and shouldn't be penalized for ignorance of the filing requirement, especially since these returns are unusual. It is not necessary to have willful neglect in order to lack reasonable cause. If a return is required under the statute and regulations, the mere uniformed belief that no return is due, no matter how genuine, is not reasonable cause. To have reasonable cause, the taxpayer must inquire of a tax professional, disclose all the relevant facts, and rely on the advice given.

Others clearly have **reasonable cause** for “failing to file” the FBARS, not because their POA says so, but because they couldn't have known under their individual circumstances. Factors indicating reasonable cause could include taxpayers who can substantiate that they did not take actions to: Hide or further tax noncompliance, and if a regular examination of unreported offshore income had taken place there would have been little or no penalties assessed. Additional factors could include little income tax, and modest account balances belonging to a recent citizen or resident of the U.S. who had previously established bank accounts in his/her native country; or perhaps a dual resident who has bank accounts established in both countries for normal banking purposes.

FBAR Penalties

- **Willful**
  - For violations occurring after 10/23/04, willful penalties can be the greater of $100,000; or 50% of the closing balance in the account as of the last day for filing the FBAR (June 30 of the following year)
- **Non-willful**
  - $10,000

FBAR penalties are determined **per account**, and apply for **each year** of the violation.

Whenever there is an FBAR violation we will either issue the FBAR Warning Letter, Letter 3800, or determine a penalty.

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Examiner Discretion

FBAR civil penalties have varying upper limits, but no floor. Examiners are expected to exercise discretion, taking into account the facts and circumstances of each case. Since FBAR penalties do not have a set amount, IRS has developed penalty mitigation guidelines to assist you in exercising this discretion so that similarly situated taxpayers will be treated more uniformly.

For most FBAR cases, the Service has determined that if a person meets four threshold conditions then the person may be subject to less than the maximum FBAR penalty depending on the amounts in the person's accounts.

For violations occurring after October 22, 2004, the four threshold conditions are:

a. The person has no history of past FBAR penalty assessments; and no history of criminal tax or BSA convictions for the preceding ten years;
b. No money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose;
c. The person cooperated during the examination (i.e., the Service did not have to resort to a summons to obtain non-privileged information; the taxpayer responded to reasonable requests for documents; meetings, and interviews; or the taxpayer back-filed correct reports); and,
d. The Service did not sustain a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account.

Continued on next page

Willful Mitigated Penalties

Mitigation guidelines for willfulness penalties occurring after October 22, 2004:

a. **Level I Willful** Violations Occurring After October 22, 2004 - If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000, Level I applies to all accounts. Determine the maximum balance during the calendar year for each account. Add the various maximums to find the maximum aggregate balance. The Level I penalty is the greater of $1,000 per violation or 5% of the maximum account balance during the calendar year for each Level I account.
b. **Level II Willful** Violations Occurring After October 22, 2004 - If Level I does not apply and if the maximum account balance to which the violations relate at any time during the calendar year did not exceed $250,000, Level II applies to that account. The Level II penalty assessed for each account is the greater of $5,000 per violation or 10% of the maximum account balance during the calendar year for each Level II account .
c. **Level III Willful** Violations Occurring After October 22, 2004 - If the maximum account balance to which the violations relate at any time during the calendar year exceeded $250,000 but did not exceed $1,000,000, Level III applies to that account. The Level III penalty assessed for each account is the greater of 10% of the maximum account balance during the calendar year for each Level III account or 50% of the closing balance in the account as of the last day for filing the FBAR .
d. **Level IV Willful** Violations Occurring After October 22, 2004 - If the maximum account balance to which the violations relate at any time during the calendar year exceeded $1 million, Level IV, the statutory maximum, applies to that account. It is the greater of $100,000 or 50% of the closing balance in the account as of the last day for filing the FBAR.

Example 19A-5:

Facts: Willful Mitigation Applies and there are 2 accounts:
Account #1 = $35,000
Account #2 = $3,000

Maximum aggregate account balances are less than $50,000, so Level 1 applies.

Continued on next page

Willful Mitigated Penalties (continued)

Penalty Computation:

Level 1 Penalty = Greater of $1,000 or 5% of highest balance in account so

Account #1	=	$1,750 (5% x $35,000) and
Account #2	=	$1,000
Total Penalty	=	$2,750

Non-Willful Mitigated Penalties

Non-Willful (NW) Penalties

a. **Level I NW** - Determine Aggregate Balances, and if the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 at any time during the year, Level 1 applies to all violations. Level I-NW Penalty is $500 for each violation, not to exceed an aggregate penalty of $5,000 for all violations.
b. **Level 2 NW** - If Level 1 does not apply, and if the maximum balance of the account to which the violations relate at any time during the calendar year did not exceed $250,000, Level II-NW applies to that account. Level 2 Penalty is $5,000 for each Level II-NW account violation, not to exceed 10% of the maximum balance in the account during the year
c. **Level 3 NW** - If Level 1 does not apply, and if the maximum balance of the account to which the violations relate at any time during the calendar year was more than $250,000, Level III-NW applies to that account. Level 3 is $10,000 for each Level 3 account violation, the statutory maximum for non-willful violations.

Example 19A-6:

Facts – Non-Willful Mitigation Applies, 2 Accounts
Account #1 = $15,000
Account #2 = $5,000

Penalty Computation:

Level 1 Penalty (Aggregate Balance Less than $50,000)
Penalty $500 per account =2 x $500 = $1,000

Continued on next page

Non-Willful Mitigated Penalties, (continued)

Example 19A-7:

Facts - Non-Willful Mitigation Applies, 2 Accounts
Account #1 = $150,000
Account #2 = $3,000

Penalty Computation:

Account 1 is a Level 2 Penalty (Lesser of $5,000 or 10% of highest balance in account) = $5,000
Account #2 (10% x $3,000) = $300
Total Penalty = $5,300

- For Failure to File FBAR – Statute is 6 years from date of violation
- Date of Violation is the date the FBAR is due; which is June 30th of following year:
    - For 2004 – FBAR Statute Expired 6/30/2011
    - For 2005 – FBAR Statute Expires 6/30/2012

FBAR Procedures

IRM 4.26.17 is very well written, and can be followed for general procedural guidance, including FBAR separate case file procedures.

Certain projects and initiatives have unique case file and other procedures, and so state of the art guidance will be provided during each class

Related Statute Memorandums

One very important consideration. These are Title 31 Examinations; so before you start an FBAR case, a Related Statute Memorandum (RSM) must be prepared and approved by management. An approved RSM allows you to use Title 26 information in the Title 31 FBAR examination.

Summary

The majority of the offshore schemes/arrangements you will investigate will include some combination of trusts, corporations, partnerships, bank and financial accounts. The most important thing to remember is to follow the money and related income, and never lose sight of the fact that ultimately the income is taxable to the taxpayer who created the arrangement, regardless of the form. Whether we disregard the entities as shams, or tax the actual beneficial owner under the Code and Regulations, the result will be the same.

If your taxpayer still owns and controls the assets and income of a trust, it is still his - whether we disregard the trust as a sham or tax it to him under the grantor trust rules of IRC §§671-679.

Whether we ignore the form and "sham" a foreign corporation beneficially owned by your taxpayer, or tax it to him under the Code - it is his income to report either way.

As you have seen, you will have extended statutes to pursue unreported offshore income, by virtue of IRC §6501(c)(8), which is even more powerful as a result of FATCA, since few if any taxpayers who created these schemes will have filed required foreign information returns.

Lastly, penalties for failure to file the foreign information reports can and should be asserted as appropriate, and may dwarf the actual related income tax.

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Exercises

Exercise 1

Jack Doe, a U.S. citizen, creates the Jack Doe Trust, a foreign trust on May 30, 2005 and transfers real estate to it on this same date. The fair market value of the real estate on the date of transfer is $5 million with an adjusted basis of $3 million. Subsequent transfers are made as follows:

- $1 million on March 7, 2006,
- real estate with a fair market value of $500,000 and an adjusted basis of $450,000 on August 20, 2006,
- stock with a fair market value of $100,000 and an adjusted basis of $50,000 on December 24, 2006 and
- $700,000 on October 11, 2007

The value of trust corpus at year end is as follows:
$5.1 M – 2005
8.0 M – 2006
9.5 M – 2007

No Forms 3520 or 3520A are filed for 2005 – 2007.

Compute the penalties under IRC §6677 for 2005 - 2007

Answer:

2005

- *Failure to file Form 3520: $1.750M (35% of $5M)*
- *Failure to file Form 3520-A: $255K (5% of trust corpus at EOY of $5.1M)*

2006

- *Failure to file Form 3520: $560K (35% of $1M, $500K and $100K)*
- *Failure to file Form 3520-A: $400,000 (5% of trust corpus at EOY of $8M)*

Continued on next page

Exercise 1 (continued)

2007

- *Failure to file Form 3520: $245,000 (35% of $700,000)*
- *Failure to file Form 3520-A: $475,000 (5% of trust corpus at EOY of 9.5M).*

Exercise 2

On October 15, 2005, Jill Doe, a U.S. citizen, transferred in an IRC § 351 transaction $100,000 cash to a foreign corporation in exchange for all its issued stock, so that Jill was the sole owner of this foreign corporation. The foreign corporation does not engage in a trade or business within the United States. Jill files no information returns for 2005.

Is Jill Doe required to file Form 5471? If yes, what would be the due date. In addition, compute the initial and continuation penalty, assuming you sent notice of the failure to file on 6/30/2008, and the taxpayer files the form on 9/20/2008. How about if the form is filed on 11/5/2008?

Answer

Jill Doe is required to file Form 5471, as a Category 4 filer.

- Initial penalty under IRC §6038(b) is $10,000.
- Continuation penalty is zero if the return is filed on 9/28/2008, which is within 90 days of notice.
- Continuation penalty is $20,000 if the return is filed on 11/5/2008, when it is 48 days past the 90 day notification period (@ $10,000 for each 30 days or fraction thereof).

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Exercise 3

As we saw in Exercise 2, on October 15, 2005, Jill Doe, a U.S. citizen, transferred in an IRC § 351 transaction $100,000 cash to a foreign corporation in exchange for all its issued stock, so that Jill was the sole owner of this foreign corporation. The foreign corporation does not engage in a trade or business within the United States. Jill files no information returns for 2005. As we discussed, Jill is required to file F5471.

Is Jill Doe required to file Form 906? If yes, what would be the due date and the amount of the penalty?

Answer:

The Form 906 was due as an attachment to a timely filed return by Jill Doe. Assuming it is after 4/15/2006, and that the personal return (Form 1040) was not on a valid extension; unless the failure to attach F906 was due to reasonable cause - the penalty is the lessor of 10% of the transfer of $100,000 which equals = $10,000, or $100,000 (per IRC § 6038B). So, the penalty is $10,000.

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International Technical Training

Chapter 19B

Foreign Information Gathering Techniques

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• None
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk • IRWeb
Participant References	• None
Equipment and Supplies	• PowerPoint slides (Prepared by instructor) • Flipcharts and markers

Overview

Introduction

The use of offshore facilities to conceal taxable income and financial transactions from the IRS is increasing. To take advantage of financial secrecy laws, tax evaders use countless methods and schemes that depend on facilities, usually banks or other types of financial institutions, which are located in foreign countries. Many of the traditional investigation tools available to agents seeking domestic information are not available when information is held in a foreign jurisdiction. Thus, investigations may be impaired because foreign documents cannot be obtained. However, there are ways to successfully obtain information from abroad.

The United States is a party to many Income Tax Treaties, which contain provisions for the exchange of information. The United States is also party to more limited agreements called Tax Information Exchange Agreements (TIEAs), which allow tax authorities to exchange tax information. Under the expanding global economy, the IRS and foreign tax administrations have made increased use of the exchange of information provisions to ensure taxpayer compliance. Exchange of Information (EOI) occurs between tax officials known as Competent Authorities.

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Contents

This lesson covers the following topics:

Continued on next page

Objectives

At the end of this lesson you will be able to:

- Compare the differences between the tax treaties and Tax Information Exchange Agreements (TIEAs)
- Identify the five Exchange of Information Programs
- Understand the information that must be included in a Specific Request
- Write an outbound specific exchange of information request
- Write an outbound simultaneous examination request
- Request information from U.S. Possession Tax Departments pursuant to information exchange agreements
- Recognize other techniques to gather foreign information.

Tax Treaties

Instructor Notes

Show the participants how to get access to Tax Treaties from:

1. www.irs.gov
2. CCH Disk

Why Do We Have Tax Treaties?

- To promote international trade and investment by minimizing double taxation.
- To permit treaty partners to better enforce their domestic tax laws.
- To provide for tax relief as well as exchange of information.

The United States has entered into income tax treaties with many countries. These treaties promote international trade and investment by allocating taxing jurisdiction between the two countries in order to minimize the double taxation of income. In addition, the treaties permit the two countries to better enforce their domestic tax laws in order to reduce tax evasion.

The tax treaties and Tax Information Exchange Agreements (TIEAs) each contain an article that requires the contracting states to exchange certain information. Although the language of the exchange of information articles varies to some extent, the IRS has generally interpreted all of the articles the same. The following is the first sentence in the exchange of information article in the United States Model Income Tax Convention (1996):

> The competent authorities of the Contracting States shall exchange such information as is relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by the Convention.

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The exchange of information articles generally cover information relevant to carrying out the provisions of the treaty or the administration of the domestic tax laws of the contracting states, if such laws are covered by the treaty and are not contrary to the purposes of the treaty. The Treasury Department’s Technical Explanation of the U.S. Model includes the following with respect to the relevancy requirement:

> The information to be exchanged is that which is relevant for carrying out the provisions of the Convention or the domestic laws of the United States or of the other Contracting State concerning the taxes covered by the Convention. Previous U.S. Models, and the OECD Model, refer to information that is “necessary” for carrying out the provisions of the Convention, etc. This term consistently has been interpreted as being equivalent to “relevant,” and as not requiring a requesting State to demonstrate that it would be disabled from enforcing its tax laws unless it obtained a particular item of information.

The United States Competent Authority has exclusive authority for making and receiving exchange of information and administrative assistance requests under all tax treaties. Information and documents obtained pursuant to a tax treaty are privileged and secret and may not be divulged except as specified in the treaty or by written consent of the foreign government.

Tax Information Exchange Agreement (TIEAs)

Instructor Notes

Show the Participants how to get access to TIEAs.

- Executive agreement; not a treaty.
- Provides for the exchange of information.
- May also provide certain trade and economic benefits in exchange.
- Number of countries involved.

The United States also has negotiated agreements with numerous foreign countries governing the exchange of tax information. These are Tax Information Exchange Agreements (TIEAs). The purpose of each TIEA is to assist each country to assure the accurate assessment and collection of taxes, to prevent fiscal fraud and evasion, and to develop improved information sources for tax matters. TIEAs are separate from tax treaties, but do not supersede an existing tax treaty.

In 1983, Congress enacted the Caribbean Basin Economic Recovery Act.

- The Act is often referred to as the Caribbean Basin Initiative (CBI).
- Congress enacted the CBI to strengthen the economies of certain countries in the Caribbean Basin by providing certain trade and tax benefits.
- Pursuant to the CBI, the United States will provide tax-related economic benefits to any country that enters into a TIEA.

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One principal difference between tax treaties and TIEAs is the latter's legal status in the United States. The authority to enter into a TIEA is in IRC § 274(h)(6)(C). A TIEA is an executive agreement that is authorized to be negotiated by the Secretary of Treasury, whereas a tax treaty requires ratification by the U.S. Senate. Another difference is that TIEAs are designed principally for the implementation of exchange of information programs between the TIEA signatories, whereas tax treaties include numerous articles designed to alleviate double taxation.

See also IRC § 927(e)(3) which limits foreign sales corporations to corporations organized in countries with which the United States has entered into a TIEA meeting the requirements of IRC §274(h)(6)(C).

In Barquero v. United States, 18 F.3d 1311 (5th Cir. 1994), the taxpayer filed a suit to quash an IRS summons for information to respond to a request for information by Mexico under the United States – Mexico TIEA. The court rejected the plaintiff's Constitutional claim and other challenges to the validity of the TIEA and to the IRS summons.

Elements of a TIEA

IRC §274(h)(6)(C)(i) requires that a TIEA provide for the exchange of information which:

- is not limited in relevance to nationals or residents of the United States or the other country;
- may be necessary and appropriate to carry out and enforce the tax laws of the United States and the other country in both criminal and civil matters;
- may otherwise be subject to nondisclosure provisions of the local law of the other country, such as provisions regarding bank secrecy and bearer shares.

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Elements of a TIEA (continued)

Paragraph 1 of Article 4 (Exchange of Information) of the Treasury Department's Draft TIEA is a follows:

> The competent authorities of the Contracting States shall exchange information to administer and enforce the domestic laws of the Contracting States concerning taxes covered by this Agreement, including information to effect the determination, assessment, and collection of tax, the recovery and enforcement of tax claims, or the investigation or prosecution of tax crimes of crimes involving the contravention of tax administration.

The Treasury Department's Technical Explanation of Article 4(1) of the Draft TIEA includes the following:

> Information may be requested in connection with, and at any stage of, a civil or criminal tax matter of the applicant State. There is no requirement that there be a tax matter or proceeding in the requested State involving the person about whom information is sought. This paragraph corresponds to and elaborates on the scope of the authority and obligation to exchange information described in the first sentence of Article 26, paragraph 1, of the U.S. Model. It describes information "necessary and appropriate to carry out the tax laws of the United States," as required by IRC § 274(h) (6) (C) (i).

Exceptions in Treaties and TIEAs to the Obligation to Exchange Information

Treaties and TIEAs relieve a Contracting State from the obligation:

- to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; or
- to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

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Limitations on the Use of Information Received Under a Treaty or TIEA

Every treaty and TIEA contains a nondisclosure provision in the exchange of information article. The nondisclosure provision applies to information received. It does not apply to information that a State sends to a Contracting State. The nondisclosure provision requires the receiving State to:

- treat the information as secret in the same manner as information obtained under the domestic laws of the State; and
- to disclose the information only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the treaty.

Treaties	TIEA
• Promote international trade and investment by minimizing double taxation • Permit treaty partners to better enforce their domestic tax laws • Provide for tax relief as well as exchange of information	• Executive agreement, not a treaty • Provides for the exchange of information • May also provide certain trade and economic benefits in exchange • Number of countries involved

Competent Authority

Instructor Notes

Have the Participants familiarize with the International LB&I Website.

Each treaty designates the Secretary of Treasury as the Competent Authority for the United States. The Competent Authority manages and approves the exchange of information requests under the treaty. The Secretary has delegated these powers and duties to the Commissioner, Internal Revenue Service, who has delegated these powers to the Deputy Commissioner, (International) LB&I. All requests for tax treaty information and all information received from a foreign country must go through the Competent Authority.

Key Point:

- Competent Authority has exclusive authority for making and receiving exchange of information and administrative assistance requests under all tax treaties.

Effective April 17, 1997, the Director, International (LMSB) currently Deputy Commissioner (International) LB&I, delegated to the Tax Attaché's (TAs) and the Revenue Service Representatives (RSRs) the authority to sign on his behalf in certain instances. Offices can forward their request for foreign-sourced information to the TAs or the RSRs whose post services the treaty partner.

Exceptions to this procedure include requests going to Australia, Canada, France and New Zealand. These requests should be submitted to the Office of the Deputy Commissioner, (International) LB&I. Requests submitted to these countries will be administered by the Exchange of Information Teams in Washington, DC. A list of program responsibilities for the Exchange of Information Team can be found at
http://lmsb.irs.gov/international/overseas/eoi/contact.asp.

Continued on next page

Exercise 19B – 1

(True or False)

1. TIEAs can override the code.

    ______True   __X__ False

2. Tax treaties help minimize double taxation.

    __X__ True   ______ False

3. The role of the competent authority is to audit foreign tax returns.

    ______True   __X__False

4. If an examiner needs information from a foreign county, she/she will contact the tax attaché or revenue service representative.

    __X__ True   ______False

Confidentiality, Disclosure and Treaty Secrecy

Information exchanged under the tax treaties and TIEAs is confidential under IRC § 6103 and/or IRC § 6105, and the terms of the tax treaty or TIEA. The treaties require both:

- That information received by IRS from a foreign government be treated as secret in the same manner as information obtained under the domestic laws of the U.S., and
- That the information may be disclosed only to persons or authorities involved in certain specified activities in the U.S. Specified persons or authorities include court and administrative bodies, personnel involved in the assessment, collection or administration of the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes covered by the treaty or TIEA, or certain oversight bodies such as Congressional tax-writing committees or GAO.

IRC § 6103 generally provides for the confidentiality of returns and return information and restricts disclosures of returns and return information.

IRC § 6103(k) (4) provides that returns and return information may be disclosed to a foreign competent authority in accordance with the tax treaty or TIEA between that country and the U.S. Most U.S. tax treaties and TIEAs contain articles providing for the exchange of information. Generally, the information received under a tax treaty or TIEA is treated as secret to the same extent as under U.S. domestic law and may be disclosed only to those persons (including courts and administrative bodies) concerned with the assessment, collection, enforcement, or prosecution of taxes specified in the tax treaties or TIEAs.

To caution against unauthorized disclosures, the Deputy Commissioner, (International) LB&I will note the following on all information exchanged under a tax treaty or TIEA: **"This information is furnished under the provisions of an income tax treaty with a foreign government. Its use and disclosure must be governed by the provisions of that treaty".**

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Generally, a taxpayer may have access to his or her tax returns and return information. However, if a taxpayer's file contains information secured from another country under a tax treaty or TIEA, the situation is different. IRC § 6103(a) provides that the taxpayer's return information may not be disclosed to any person if it is determined that the disclosure would seriously impair Federal tax administration. Questions concerning the disclosure and use of tax treaty/TIEA information must be coordinated with LB&I Disclosure personnel and if necessary, with Counsel.

Under IRC § 6103(p)(3), IRS Tax Attaché's, Revenue Service Representatives and the Office of Overseas Operations, Exchange of Information (EOI), must account for disclosures of returns and return information to third parties other than those exempt under IRC § 6103(p)(3)(A), which includes disclosures to a foreign competent authority. The IRM on Disclosure of Official Information provides information on accounting for written and oral disclosures of information.

Contacts with Foreign Governments

No IRS employee should make direct contact with a foreign tax official without first contacting the jurisdictional IRS Tax Attaché (TA), Revenue Service Representative (RSR) or the Office of Overseas Operations, Exchange of Information (EOI). If a foreign official directly contacts an IRS office, the IRS office should refer the contact to the IRS TA, RSR or EOI.

No information, oral or written, should be disclosed to a foreign government outside the U.S. Competent Authority channels. All tax-related information must be formally exchanged through the established Competent Authority channels. **There are no provisions for informal exchanges.**

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Third-Party Contacts

Key Point:

- Taxpayer contact notifications are not warranted for an exchange of information request per Treas. Regs. § 301.7602-2 (f)(5) – Governmental entities.
- Section 7602(c) does not apply to any contact with any office of any local, state, Federal or foreign governmental entity except for contacts concerning the taxpayer's business with the government office contacted, such as the taxpayer's contracts with or employment by the office. The term office includes any agent or contractor of the office acting in such capacity.

Exercise 19B – 2

1. Can an examiner make direct contact with a foreign tax official?

Answer:

No IRS employee should make direct contact with a foreign tax official without first contacting the jurisdictional IRS Tax Attaché (TA), Revenue Service Representative (RSR) or the Office of Overseas Operations, Exchange of Information (EOI).

2. What section of the Code on third-party contacts does not apply to government entities?

Answer:

IRC section 7602© does not apply to any contact with any office of any local, state, Federal or foreign governmental entity except for contacts concerning the taxpayer's business with the government office contacted such as the taxpayer's contracts with or employment by the office. The term office includes any agent or contractor of the office acting in such capacity.

Exchange of Information Programs

Instructor Notes

Show the Participants how to get access to:

1. the Exchange of Information Website, and
2. IRM 4.60.1.2.

Don’t spend too much time on Simultaneous Exchange Program. Overview only. Not generally an issue for individual filers.

There are five types of Exchange of Information programs:

- Specific Requests
- Spontaneous Exchanges
- Automatic/Routine Exchanges
- Simultaneous Examinations
- Industrywide Exchanges

Specific Requests

A specific request is a treaty request for examination or investigative information from either IRS or a foreign treaty partner to be provided to the other. The entity under examination or investigation may be an individual or a business. Requests for information are not limited to requests for copies of documents or records; they may also request assistance for such things as conducting interviews of witnesses, locating an individual, or determining if a business is operating in a particular country.

When to Make a Specific Request

A specific request should be made when the facts reveal that information is likely to be located outside the United States, efforts to obtain the information in the United States have been unsuccessful, and there is sufficient time to secure the information.

Prior to drafting the request, make contact with the Tax Attaché, Revenue Service Representative or Exchange of Information Analyst responsible for the country where the assistance is to be requested to ensure that all relevant matters pertaining to the request are considered.

Guideline: The information to be included in a specific request is outlined in IRM 4.60.1.2.

How to Make a Specific Request

A request for information pursuant to a tax treaty or TIEA should be sent to the IRS Tax Attaché (TA) or Revenue Service Representative (RSR) who has jurisdiction for the country where the information is located. When no IRS TA or RSR has jurisdiction for the foreign country or if the request involves Australia, Canada, France, or New Zealand, send the request to Manager, Exchange of Information Team, 1111 Constitution Avenue, NW, LB:CA&IC:EOI/OO, Washington, DC 20224-0002. An exchange of information program analyst, a TA, or a RSR will prepare a letter to the foreign tax administration requesting the needed information.

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U.S. Initiated Specific Request Procedures

The request will consist of two parts. The first part is the cover memorandum which includes:

a. The name of the taxpayer under examination or investigation
b. The name and telephone number of the requester
c. The address where there response should be mailed or the fax number where the response should be faxed
d. Any background or administrative information that should NOT be provided to the foreign tax administration
e. Any statute, court or similar dates by which the information is needed
f. Whether or not the request includes grand jury information

The second part is an attachment on plain paper which can be forwarded to the foreign tax administration, and which includes:

a. The name, address, date of birth of the taxpayer under examination or investigation
b. The type of tax, the calendar or fiscal tax years involved
c. General information about the case to establish that a tax examination or investigation is being conducted
d. Location of the information, including an explanation why we believe that it is in the foreign country
e. The specific information needed
f. How the information is relevant to the examination or investigation
g. Any statute, court or similar dates by which the information is needed
h. Whether copies of documents secured need to be certified.

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U.S. Initiated Specific Request Procedures (continued)

The IRS TA, RSR or Exchange of Information Program Analyst (EOIPA) assigned to the case will provide a status report on the case every 60 days. If a status report is needed sooner, the requester should contact the IRS TA, RSR or EOIPA directly.

Once the information is secured from the treaty partner, the response will be reviewed by the IRS TA, RSR or EOIPA to ensure all information requested was provided. The information will then be sent to the requester. If only a portion of the information is received, it may still be provided to the requester. This is deemed a partial reply. The IRS TA, RSR or EOIPA will follow up with the treaty partner to ensure that all of the requested information is provided.

The IRS Tax Attaché (TA), Revenue Service Representative (RSR) or Exchange of Information Program Analyst (EOIPA) will forward foreign initiated requests to the appropriate office for action.

Foreign Initiated Specific Request Procedures

Under the Memorandum of Understanding (MOU) between Large Business and International (LB&I) and Small Business/Self-Employed (SB/SE), the IRS TA, RSR or EOIPA will forward the case as follows:

- Cases involving SBSE entities and issues will go the SB/SE Directors, Examination Area for assignment to a Revenue Agent (RA).
- Upon receipt by the Field Office, the manager will confirm receipt with the IRS TA, RSR or EOIPA and provide the assignment information, including contact numbers and the name of the RA assigned to the case.
- The RA will obtain the requested information within 60 days from the date of the transmitting memorandum. If the RA is unable to meet the deadline, the RA will contact the IRS TA, RSR or EOIPA to provide a status report and the estimated completion date.
- The tax treaties authorize the IRS to use the same investigative techniques and procedures to obtain information for a treaty partner that it would use to obtain information incident to a domestic tax investigation. The treaties provide each treaty country with the obligation to furnish any information which is obtainable under its laws or in the normal administration of its tax laws.

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Foreign Initiated Specific Request Procedures (continued)

Many requests are for information that can be secured by simply interviewing a witness (corporate officer, relative, etc.) or making a search of public records. Other requests are for documents such as bank records or brokerage records. An attempt should be made to obtain the information voluntarily; however, if it becomes necessary, a summons can be issued.

If it is determined that a summons is needed after the case assignment, contact the IRS TA, RSR or EOIPA for assistance with summons preparation.

When the requested information is secured, the information should be submitted in the following format:

1. All administrative information should be included in the cover memorandum.
2. The following should be contained in the attachment:
   a. The report should be typed on plain bond paper and should not contain the name of the agent who prepared the report. Supporting documents should be attached and clearly labeled.
   b. If the attachments are voluminous, a cover sheet should be included outlining the information included in the attachments.
   c. Negative replies should outline the steps taken in attempting to locate the information.

If tax return information is requested, you may request the taxpayer's retained copy. The retained copy should be verified by obtaining a transcript and comparing the copy to it. The returns should be analyzed and the information requested by the treaty partner should be summarized in your report.

The RA will forward the information to the IRS TA, RSR or EOIPA. The RA will also send a copy to the Director, Examination Area, if requested. If any of the information should not be disclosed to the treaty partner, include a written recommendation stating the reason that the information should not be disclosed.

Continued on next page

Foreign Initiated Specific Request Procedures (continued**)**

The IRS TA and RSR, on behalf of the U.S. Competent Authority, will forward the information to the foreign Competent Authority. If the information is not provided, the IRS TA or RSR will provide the foreign Competent Authority with an explanation of why the information was not provided. Cases assigned to the EOIPA will be processed and submitted through proper channels for signature by the U.S. Competent Authority. Once the correspondence has been signed, the information will be forwarded to the foreign Competent Authority.

Foreign Initiated Specific Request Confidentiality

Foreign initiated specific requests for information do not require the opening of an examination. The facts and circumstances of each case should dictate whether there is a need for an examination. If a U.S. examination is opened, advise the EOIPA.

When securing information for a foreign treaty partner, the same principles of disclosure used in domestic tax investigations apply. You may disclose as much information as is necessary, without actually showing a copy of the treaty partner's request, in order to secure the information needed to adequately respond to the request. You may, and should, tell the witness or third-party record holder that you are securing the information for a foreign government under the provisions of the treaty. This is to avoid the implication that there is a U.S. tax investigation in process.

Counsel Involvement

A summons may be required in cases where the taxpayer or third party refuses to provide the information requested by the treaty partner. Because we are seeking information on behalf of a foreign government, Associate Chief Counsel International, Branch 7 will provide guidance on issuance and enforcement of summonses and work with local counsel as appropriate.

Summonses pertaining to specific requests from treaty partners can only be prepared by the IRS Tax Attaché (TA), Revenue Service Representative (RSR) or Exchange of Information Program Analyst (EOIPA) assigned to the treaty request. These summonses require approval from the Associate Chief Counsel International, Branch 7. Contact the TA, RSR or EOIPA immediately if a summons is warranted.

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Note:
There are exceptions to specific requests such as Trade Secrets. Generally, tax treaties and TIEAs provide for the nondisclosure of any trade, business, industrial, commercial or professional secret or process. In the event there is a disagreement between the IRS and a third party concerning the protection of the trade secret or process, etc., the third party should follow the procedures in Rev. Proc. 77-16, 1977-1 CB 573, as amplified by Rev. Proc. 79-32, 1979-1 CB 599. These procedures provide guidance for requesting assistance from the U.S. Competent Authority to determine the availability to a U.S. taxpayer of benefits and safeguards provided under the income tax treaties. Tax examination in progress will continue while the request is being considered, unless the U.S. Competent Authority directs otherwise.

Spontaneous Exchange of Information

A spontaneous exchange of information is:

- furnished to a tax treaty/TIEA partner without a previous specific request.
- information discovered during a tax examination, investigation or other procedure.
- information which suggests or establishes noncompliance with the tax laws of a tax treaty/TIEA partner relating to a tax covered by the treaty.

The examiner securing the information will forward it to the second level manager. The second level manager will forward the information to the IRS Tax Attaché or Revenue Service Representative who has jurisdiction over the country to which the information pertains.

For Australia, Canada, France and New Zealand, the information should be sent to:

> Director, International Exchange of Information
> 1111 Constitution Ave., NW
> LB:CA&IC:EOI/OO
> Washington, DC 20224-0002

Automatic/Routine Exchange of Information

Under this program, States (Treaty Partners) agree to exchange information that identifies taxpayer recipients of passive or investment income (dividends, interest, rents, and royalties). This program generates the largest amount of exchanges of information. Information received by the United States in routine exchanges is retained by the Philadelphia Service Center on a Form 1099-type format and made a part of the Service's Information Retrieval Program (IRP).

Simultaneous Exchange of Information

The Simultaneous Examination Program (SEP) operates through the exchange of information provisions of income tax treaties and TIEAs. The program is coordinated through the U.S. Competent Authority, who is the Deputy Commissioner, (International) LB&I. Simultaneous examinations may be carried out pursuant to written Working Arrangements entered into by the Deputy Commissioner, (International) LB&I and the Competent Authorities of one or more of our tax treaty and TIEA partners. This program is designed to facilitate the exchange of information between the U.S. and its treaty partners and to coordinate the tax examination of business entities with activities in more than one country.

Note: Currently the U.S. has Working Arrangements with Australia, Canada, France, Germany, Italy, Korea, Japan, Mexico, Norway, Philippines, Sweden and the United Kingdom.

Purpose, Objective and Benefits of Simultaneous Exchange of Information

Simultaneous Examinations involve the U.S. and one or more of its tax treaty or TIEA partners conducting separate, independent examinations of the taxpayer or a related taxpayer within their jurisdiction. The purpose of the simultaneous examination is to determine the correct tax liabilities of the taxpayer and/or related entities. The objective is to facilitate exchanges of information and to mutually secure other tax compliance benefits. The compliance benefits which may result from a simultaneous examination include:

- The assessment of tax based on a more complete factual development of the circumstances pertaining to the tax liability;
- The exchange of information on apparent tax avoidance techniques or patterns;
- The exchange of information on tax haven transactions;
- The exchange of information on cost-sharing arrangements;
- The exchange of information on profit allocation methods in special fields such as global trading and new financial instruments;
- A more thorough understanding of multinational business practices, complex transactions, and examination issues that may be particular to an industry or group of industries; and
- The identification of noncompliance trends in a market segment.

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Purpose, Objective and Benefits of Simultaneous Exchange of Information (continued)

A simultaneous examination may also enable examiners to build more complete factual evidence for tax adjustments for which the Mutual Agreement Procedure might be requested. A simultaneous examination may also enable taxpayers to make a request for Competent Authority consideration at an earlier stage than might otherwise have been the case.

Basis for a Simultaneous Exchange Program

While simultaneous examinations are most often conducted on a bilateral basis, a multilateral simultaneous examination is possible in cases where there is a legal basis for the exchange of information between all of the potential participating countries. A multilateral simultaneous examination does not expand the scope of permissible exchanges under the treaties or TIEAs pursuant to which the examination is conducted.

Example:

A multilateral examination involving France, Germany, the United Kingdom and the United States, or any combination of those countries, is possible since all of these countries have income tax treaties with each other. Similar treaty relationships between Australia, Canada, Japan and the United States also create the possibility of a multilateral simultaneous examination among some or all of those countries.

Reminder:

In cases where the United States has income tax treaties or TIEAs with two or more potential participating countries which do not have exchange of information provisions among themselves, (e.g., Germany and Japan), parallel bilateral simultaneous examinations may still be possible. Contact the Simultaneous Examination Program Analyst for other possible cooperative exchange efforts.

Continued on next page

Basis for a Simultaneous Exchange Program (continued)

Example (continued):

Specific exchanges of information between the U.S. and tax treaty or TIEA partners are conducted on a bilateral basis according to the applicable income tax treaty or TIEA. The U.S. will not provide information received from one tax treaty partner to another, either in the framework of a bilateral simultaneous examination or in a multilateral simultaneous examination. This would violate the secrecy provisions of the tax treaty or TIEA with the country providing the information.

Compliance Benefits:

1. ____
2. ____
3. ____
4. ____
5. ____

Simultaneous Exchange Program Recommendations Criteria

While the taxpayers selected for simultaneous examination are often large multinational corporations, simultaneous examinations may also involve individuals and partnerships.

Cases considered for simultaneous examination may involve, but are not limited to:

a. A taxpayer or related taxpayers with business transactions or a business nexus in the participating countries;
b. Operations by the taxpayer or related group of taxpayers which are significant in scale, either worldwide or within the participating countries;
c. An issue or issues which would be relevant to the participating countries in one or more compatible years. These issues may include, for example, transfer pricing practices, potential international tax avoidance techniques, and potential noncompliance trends in a market segment; or
d. A potential for mutual benefit to be gained by the tax administrators of the participating countries.

SEP Proposal and Acceptance Procedures

Proposals for simultaneous examination may be initiated by either the U.S. or a tax treaty or TIEA partner. The Competent Authority of the initiating country transmits its proposal in writing to the other Competent Authority. The proposing Competent Authority will set forth the criteria used in deciding to propose the case along with such other available information as may be useful to the receiving Competent Authority (e.g., information about the taxpayer's business organizational structure, functions, products, intangible assets, etc.).

Continued on next page

Simultaneous Exchange Program Recommendations Criteria, Continued

U.S. Initiated Proposals

U.S. recommendations for a simultaneous examination will be prepared and forwarded to the following:

Manager, Exchange of Information Team
1111 Constitution Ave., NW
LB:CA&IC:EOI/OO
Washington, DC 20224-0002

Parts I, II and III of the proposal will be transmitted by the Director, International (LB&I) to the foreign competent authority. Parts II and III require a written narrative and are not limited to any specific length. Information within the parentheses is intended to provide assistance to the examiner when preparing the narrative section of the format proposal. The directive information within the parentheses need not be included in the field's recommendation sent to the Manager, Exchange of Information Team.

The Deputy Commissioner, (International) LB&I, as U.S. Competent Authority, will send the proposal to the foreign Competent Authority along with an appropriate transmittal letter. Within the transmittal, the field agent should include the name of the person(s) who will function as the U.S. Competent Authority's Designated Representative should the simultaneous examination be accepted. (This will generally be the Team Manager.) When a response is received, the Manager, Exchange of Information Team will advise the field.

Foreign Competent Authorities generally consider proposals for a simultaneous examination in conjunction with any information they already have and the potential benefits that may be gained from a simultaneous examination. It is therefore important that the narrative in Part II gives the foreign tax authorities a clear understanding of the basis for the proposal for a simultaneous examination. Examiners and Managers considering a simultaneous examination recommendation are encouraged to contact the Manager, EOI or the IRS Tax Attaché or Revenue Service Representative for assistance with questions regarding a treaty partner's laws, administrative practices, statutes of limitations, or any other aspect of a potential simultaneous examination proposal.

Continued on next page

U.S. Initiated Proposals (continued)

Part III attempts to show the potential benefits that a simultaneous examination of a proposed case would yield. In may instances, examinations may not have progressed to a point where specific amounts, either of tax or of adjustments to income, can be determine or estimated. In those cases, it should be plainly stated that no estimate is given; a brief description of how the estimate was arrived at should be provided.

Part IV is intended to provide administration information to the Office of the Deputy Commissioner, (International) LB&I and is for that use only. Part IV is not part of the proposal submitted to the foreign Competent Authority.

Foreign Initiated Proposals

Foreign initiated proposals received by the Deputy Commissioner, (International) LB&I will be transmitted to the appropriate office having jurisdiction over the taxpayer.

a. Within 60 calendar days of the receipt of a simultaneous examination proposal, the International Territory Manager will transmit a memorandum to the Manager, Exchange of Information Team, advising whether the field will participate in the foreign initiated simultaneous examination proposal.
b. If the field accepts the foreign initiated proposal, the memorandum will also provide the name, address and phone number of the manager who will function as the U.S. Competent Authority's Designated Representative.
c. If the proposal is not accepted, the memorandum will give the reasons for declining the proposal. In addition, any available information which may be of use to the proposing Competent Authority will also be included with the memorandum, whether the field is accepting or declining the proposal.

The Deputy Commissioner, (International) LB&I is responsible for the response to the foreign tax treaty/TIEA partner and must transmit any information provided by the field to the foreign Competent Authority.

Conducting of Simultaneous Examinations

When a case is accepted for simultaneous examination, the responding Competent Authority will confirm acceptance in writing and will identify a designated representative who will have functional responsibility for directing that country's examination. After receiving confirmation, the proposing Competent Authority will confirm the designated representative.

Any meetings between the designated representatives will be coordinated with the SEP program analyst – in the Office of the Deputy Commissioner, (International) LB&I and the foreign government – who will prepare the necessary Competent Authority correspondence and attend all meetings to oversee the exchange of information process. All information must be exchanged by the Competent Authority or his/her designee with delegated authority.

The meetings may take place either in the U.S. or in the foreign country. Therefore, the U.S. designated representative and other members of the examination team who will be taking part in the meetings should initiate steps to secure U.S. Official Passports through the International Travel Office, ATTN: LB:CA&IC:ITVP.

- Requests for foreign travel should be submitted far enough in advance of planned travel to allow the International Travel Office 30 to 45 days to process the request.
- The Travel Handbook describes travel outside the U.S. by examination personnel and travel to Canada.

Note: All travel cost connected with a simultaneous examination will be borne by the office to which the participants are assigned. The Deputy Commissioner, (International) LB&I, as Competent Authority, reserves the right to limit participants.

Meetings held in conjunction with the Simultaneous Examination will consider the audit plans of the participating countries (although there is no exchange of formal audit plans), the possible issues to be developed, timetables and target dates for the examination and approaches to be taken. Other considerations during the Simultaneous Examination meeting will include what documents, records, etc., might need to be requested through the Simultaneous Examination Program.

Continued on next page

The designated representative for the U.S. in a Simultaneous Examination is NOT authorized to perform the functions of the Deputy Commissioner, (International) LB&I as the U.S. Competent Authority under U.S. tax treaties and TIEAs. The designated representative will not exchange any information directly with the foreign Competent Authority or his or her designated representative.

All exchanges will be carried out by the Competent Authorities in accordance with the applicable treaty or agreement. The U.S. designated representative will, however, initiate requests for specific information as generated during the simultaneous examination process to the other participating country or countries, and may be required to act upon requests received by the Deputy Commissioner, (International) LB&I from the other participating countries.

If issues arise during a simultaneous examination which may lead to double taxation, the U.S. designated representative will inform the Deputy Commissioner, (International) LB&I of the details by way of a memorandum to the Manager, Exchange of Information, LB:CA&IC:EOI/OO, as soon as practical.

1. The Manager, Exchange of Information, will consult with the Manager, Tax Treaty and, if appropriate, a Competent Authority analyst may become a consultant to, or a member of, the U.S. examination team.
2. In those instances, the Competent Authority analyst will be responsible for providing direction to the examiners as to the factual development necessary for any issues which could become subject to the Mutual Agreement Procedures (MAP).
3. U.S. examiners in such cases will limit themselves to development of the facts and will not try to negotiate the resolution of double taxation issues. The Deputy Commissioner, (International) LB&I is the only person who has this authority.
4. The presence of a Competent Authority analyst as a member of, or a consultant to, the examination team does not alter the requirement of Section 1.2.1 of this handbook, concerning the issuance of Letter 1853(P), right to Request Competent Authority Consideration Letter, to the taxpayer, nor does it relieve the taxpayer of its need to request Competent Authority consideration pursuant to Rev. Proc. 2002-52, 2002 31 and IRB 242.

Continued on next page

Any participating country may discontinue participation in a simultaneous examination once it concludes that it would no longer be of benefit.

a. A U.S. initiated discontinuance would be initiated by the U.S. designated representative through a memorandum to the Manager, Exchange of Information, stating the reason that discontinuance is recommended.
b. Upon acceptance of such a recommendation, the Deputy Commissioner, (International) LB&I will send a notification letter to the foreign Competent Authority or Authorities and U.S. participation in the simultaneous examination will end.

A simultaneous examination will be concluded at such time as the designated representatives mutually agree.

Other SEP Considerations

U.S. taxpayers who have been accepted for simultaneous examination will be informed of the fact by the manager responsible for the U.S. examination.

Note: Since simultaneous examinations are independent examinations conducted by each of the participating countries according to their own laws and procedures, the taxpayer's consent to a simultaneous examination is not required.

Since exchanges of information with foreign tax treaty or TIEA partners result from a simultaneous examination, taxpayers may resist information requests or seek to impose restrictions or conditions on its disclosure to a foreign Competent Authority.

- Managers and examiners should reject any such conditions or restrictions and should not give any assurances that information will not be exchanged or that the taxpayer will be consulted before any exchange.
- Any such assurances given will not be binding on the IRS or the U.S. Competent Authority, except as indicated below.

Continued on next page

Other SEP Considerations (continued)

EXCEPTION: If a request for information is resisted by a taxpayer on the basis of its possible disclosure to a foreign Competent Authority, the case or group manager should attempt to obtain a comprehensive explanation of the legal and factual grounds for the taxpayer's objections (such as a claim that the information constitutes a trade or business secret) and consult with Counsel. If the manager having jurisdiction over the case and Counsel consider that it would be appropriate to agree that any items of information may not be exchanged, or may not be exchanged without prior notice to the taxpayer, they will first secure the written consent of the Deputy Commissioner, (International) LB&I before agreeing to any such conditions.

- Meetings may take place either in the U.S. or in a foreign country.
- Meetings will include the audit plans of the participating countries, the possible issues to be developed, timetables and target dates for the examination, and approaches.
- Meetings will include what documents, records, etc. might need to be requested.
- Any participating country may discontinue participation once it concludes that it would no longer be of benefit.
- A simultaneous examination will be concluded at such time as the designated representatives mutually agree.

Industrywide Exchanges of Information

Industrywide exchanges of information with tax treaty or TIEA partners promote international cooperation in understanding worldwide operations of selected major industries.

The principal objective of the exchange is to secure comprehensive data on worldwide industry practices and operating patterns. This information enables a more effective and knowledgeable review of the tax returns of multinational enterprises.

The scope of an industrywide exchange is established by an exchange of letters between the U.S. and the tax treaty or TIEA partner Competent Authorities. Generally, the Deputy Commissioner, (International) LB&I will select a Designated Representative to coordinate to industrywide exchange.

The Deputy Commissioner, (International) LB&I will communicate with the tax treaty or TIEA partner Competent Authority on all matters relating to industrywide exchanges of information.

Industrywide exchanges are conducted by tax officials of each country meeting periodically to:

- Discuss current industry events of mutual interest;
- Jointly explore common issues;
- Pool resources for special studies;
- Discuss comparative methodology in establishing arm's length standards;
- Conduct seminars on major international issues; and
- Cooperate on new and emerging issues.

During an industrywide exchange, taxpayers are not discussed and no taxpayer information is exchanged. Any request made by a treaty partner for specific taxpayer information is handled in accordance with the exchange of information articles of the tax treaties or TIEAs, under the Specific Exchange of Information Program.

Continued on next page

Any information obtained at an industrywide exchange should only be disclosed to those persons whose official tax administration duties with respect to the industry issues requires such a disclosure. An example is the Organization for Economic Co-operation and Development (OECD). Their web site is: www.oecd.org

Exercise 19B – 3

1. What are the five Exchanges of Information Programs?

   Answer:

   - Specific Requests
   - Spontaneous Exchanges
   - Automatic/Routine Exchanges
   - Simultaneous Examination
   - Industrywide Exchanges

2. What part of the IRM would you visit to understand what information is needed in a specific request?

   Answer:

   IRM 4.60.1.2.1.

3. Who can you contact if you have questions dealing with any of the Exchange of Information programs?

   Answer:

   Manager, Exchange of Information Team
   1111 Constitution Ave., NW
   LB:CA&IC:EOI/OO
   Washington, DC 20224-0002

Securing Information from U.S. Possessions

Instructor Notes

Go over Form 8796 with the Participants.

In addition to requesting offshore information from foreign countries through tax treaties and TIEAs, revenue agents can also request tax returns and return information located in the U.S. possessions. As with the 50 states in the U.S., the IRS enters into information exchange agreements that contain authorization and general procedures for the exchange of information between the IRS and each Possession Tax Department. These agreements, titled Coordination Agreements and Implementation Agreements, identify the type of information to be exchanged, disclosure limitations, and request procedures.

In addition, a series of Memorandums of Understanding (MOUs) have been executed between the Internal Revenue Service Small Business/ Self Employed Division (SB/SE) and tax departments for several of the U.S. possessions. The office of the National Governmental Liaison is responsible for coordinating the execution, implementation, and monitoring of the MOUs with the U.S. possessions. MOUs are generally executed when the U.S. possession tax department and the IRS mutually agree in writing to a joint project that may be for a limited duration (normally for a 3-year period). MOUs contain more details than the Coordination and Implementation Agreements and outline the exact request procedures, the roles and responsibilities of each party, and other relevant issues. Specific information relevant to the project is identified and is exchanged between the parties.

The majority of SB/SE's MOUs currently in place with the U.S. possessions involve Puerto Rico, the U.S. Virgin Islands, and Guam.

While the MOUs facilitate information sharing for tax administration purposes, their content is protected under the Disclosure regulations outlined in the IRC § 6105. As such, copies of the actual MOUs can only be released by the U.S. Competent Authority.

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Instructor Notes

Show the Participants how to access the Website on LB&I – International.

Procedures for Requesting Return(s) or Return Information from the U.S. Possessions:

Form 8796, *Request for Return/Information (Federal/State Tax Exchange Program)*, should be used by IRS personnel in requesting return(s) or return information from the tax departments of the U.S. possessions. The revenue agent requesting the information should do the following:

- Complete Sections A, B and C of Form 8796.
- Obtain approval/signature from the designated official from the Fed/State (U.S. Possessions) Authorization list.
- Route Form 8796 to the Disclosure Officer of the tax department in the possession from which the information is being sought. If the revenue agent cannot secure the authorized signature locally, he/she should route Form 8796 to International Disclosure at the following address. (Disclosure will sign and route the request to the possession tax department.)

  Internal Revenue Service
  Disclosure Office
  31 Hopkins Plaza, Room #1210
  Baltimore, MD 21201
  Joan McClean (Disclosure Officer): PH# 410-962-0799

- The requested information will be mailed directly to the revenue agent by the Possession Tax Department.

Obtaining Evidence from Abroad Judicially

There are several methods of obtaining evidence from abroad using judicial means. Two of these methods will be discussed below: Letters Rogatory and Letters of Request. Each of these methods is used in judicial proceedings and requires the court in one country to initiate a request to a court or competent authority in another country to obtain evidence, or to perform some other judicial act. The U.S Attorney handling the case is responsible for requesting that a Federal court utilize these methods. A revenue agent, working with the U.S. Attorney on a specific case, may have input on what documents may be requested, and/or review those documents when secured from a foreign jurisdiction.

Letters Rogatory

Letters rogatory exist as a form of comity between nations and are a customary practice that has existed for centuries. They are a formal written request from a court or judge in one country to the appropriate legal authority in another country. The type of assistance requested can range from effecting service of process to the taking of testimony or the obtaining of documents and records. Letters rogatory can be obtained only in connection with civil or criminal litigation or grand jury proceedings and an action must be pending in the requesting court.

The potential usefulness of letters rogatory depends on the foreign country involved and on the type of judicial assistance being requested. The type of assistance that will be given is completely within the control of the foreign court involved. Thus, many countries will not honor requests which have been issued for pre-trial discovery purposes. Foreign courts might also refuse to cooperate because the request involves the enforcement of tax or fiscal matters, because bank secrecy laws are involved, or for other reasons relating to the policies of the foreign government.

After the judge signs the letters rogatory it is transmitted through diplomatic channels (State Department) to the appropriate legal authority in the foreign country.

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Letters Rogatory (continued)

Use of letters rogatory frequently involves procedural difficulties. For example, if the court to receive the request is in a non-English-speaking country, it will be necessary to translate the request as well as any pertinent documents. Since the translations must be certified, this can be a time-consuming process. Also, many countries require that letters rogatory be transmitted through the State Department and their own foreign ministry or foreign office rather than directly from court to court.

Letters rogatory is a cumbersome and time-consuming process and is primarily used if it is the only method available to secure evidence. International Counsel has emphasized that there is little need to use letters rogatory when a Letter of Request can accomplish the same purpose with much less effort.

Letters of Request (Hague Evidence Convention)

The Convention on the Taking of Evidence Abroad in Civil or Commercial Matters (the **Hague Evidence Convention**) is an international treaty which provides various methods and standardized procedures for taking evidence in civil and commercial transnational disputes.

Essentially, the Hague Evidence Convention codifies the age-old practice of letters rogatory, streamlines the process, and provides for Letters of Request, rather than letters rogatory, that can bypass foreign courts and diplomatic channels. This procedure cannot be used to obtain information from jurisdictions other than those who have signed the Hague Evidence Convention (not all countries have signed the Convention: See Master List of Treaties (revised on 4/13/06)).

Although Letters of Request are essentially an administrative tool, with requests worked by the Central Authority in the receiving country, they must be initiated by the court in the originating country and are **not an investigative tool.**

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Letters of Request (Hague Evidence Convention) (continued)

Per the Convention, a litigant may request the court where the action is pending to transmit a Letters of Request to the Central Authority in the foreign country where the evidence is located requesting such authority to obtain evidence or to perform some other judicial act. The Central Authority, selected by the foreign government, then transmits the request to the appropriate court or authority, which conducts the evidentiary proceeding.

The fact that a nation is a signatory to the Hague Evidence Convention does not necessarily mean that the U.S. government will receive the same type of assistance from each country. Most common law countries will provide assistance under the Hague Evidence Convention in civil tax cases pending in a court within the United States. However, many civil law countries consider tax matters as “fiscal” matters that are not within the scope of the Convention. In addition, many countries require enabling legislation to implement international agreements. Often, as in British Commonwealth countries, that legislation modifies their actions under the convention. Accordingly, International Counsel will have to be consulted to determine what can be expected from any given jurisdiction.

Letters of Request differ from letters rogatory in that they do not have to go through legal or diplomatic channels. The letters go directly to the Central Authority in the foreign jurisdiction. The Central Authority for the United States is the Department of Justice, Office of Foreign Litigation.

It is estimated that it will take between 6-12 months to secure information through Letters of Request.

References

- IRM Part 35.4.5.3: Obtaining Evidence From Abroad Judicially
- Extensive information relating to obtaining evidence from abroad, Letters Rogatory, and Letters of Request (the Hague Evidence Convention) is located on the U.S. Department of State website: http://travel.state.gov/law/info/judicial/judicial. This information can be viewed by accessing “Information for Americans Abroad – Judicial Assistance” and “Legal and Public Policy Information – Treaties”.

Mutual Legal Assistance Treaties (MLATs)

Mutual Legal Assistance Treaties (MLATs) create a routine channel for obtaining a broad range of legal assistance for criminal matters. These treaties are concluded by the United States Department of Justice (primarily the Criminal Division) in conjunction with the United States Department of State. Every MLAT specifies central authorities to act on behalf of each treaty partner to make requests, to receive and execute requests, and to generally administer the treaty relationship. Each treaty designates the Attorney General as the Competent Authority for the United States. The Attorney General has delegated these powers and duties to the Assistant Attorney General of the Criminal Division.

MLATs are designed to facilitate the exchange of information and evidence for use in criminal investigation and prosecution, and create a contractual obligation between the treaty partners to render assistance to each other in criminal matters in accordance with the terms of the treaty.

Assistance is available under the MLAT once an investigation or prosecution has been initiated by an appropriate law enforcement or judicial authority in the requesting state. Thus, the United States may initiate a request for assistance under an MLAT when a criminal matter is at the trial stage, or is under investigation by a prosecutor, a grand jury, or an agency with criminal law enforcement responsibilities.

MLAT requests are made by the Criminal Investigation Division of the Internal Revenue Service. The treaties include the power to summon witnesses, to compel the production of documents and other real evidence, to issue search warrants, and to serve process. One of the principal purposes of an MLAT is to ensure that the evidence secured through the treaty is admissible in court proceedings that are being conducted in the requesting country.

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Mutual Legal Assistance Treaties (MLATs) are:

- Used in criminal matters to facilitate the exchange of information and evidence,
- Used to summon witnesses,
- Used to issue search warrants, and
- With such treaties, the Attorney General (AG) is the Competent Authority for the United States. The AG has delegated these powers and duties to the Assistant AG of Criminal Division.

Many of the MLATs currently in force cover most U.S. tax felonies. Unfortunately, however, many of the MLATs with “offshore financial centers” contain a variety of restrictions regarding assistance for U.S. tax offenses. For example, the Swiss MLAT excludes tax and similar fiscal offenses from its scope except in cases involving organized crime. In addition, Cayman and Bahamian MLATs generally exclude offenses relating to tax laws except for tax matters arising from unlawful activities otherwise covered by the MLATs. The Swiss, Cayman, and Bahamian MLATs contain specific limitations on the use of evidence obtained for covered offenses. Accordingly, such evidence is generally not available for tax purposes in civil or criminal investigations or proceedings which are subsequently conducted.

Generally, MLATs provide that the requested state may impose conditions on the use of information or evidence furnished under their provisions (including confidentiality). The requesting state must use its best efforts to comply with the conditions. Although some MLATs are more restrictive, generally, once the information or evidence properly used in the investigation or prosecution becomes a matter of public record in the requesting state, it may be used for any purpose.

MLATs usually provide that all original documents, records, or articles of evidence provided pursuant to an MLAT request must be returned to the state that provided the items. Generally, copies of documents provided under an MLAT do not need to be returned unless the state which provides the copies specifically requests their return.

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A revenue agent would not attempt to secure assistance (the production of books, records, documents, etc.) through an MLAT. When a field agent refers a case to the Criminal Investigation Division, it becomes a numbered case, and CID is responsible for conducting the criminal investigation. CID would initiate a request for assistance through the MLAT if they are unable to secure that assistance or information through a summons, a tax treaty, or a tax information exchange agreement (TIEA). However, a revenue agent may eventually gain access to information that was secured by the Criminal Investigation Division thorough the MLAT.

Example:

A revenue agent made a criminal referral on a taxpayer for unreported income for the 1998 and 1999 tax years. CID accepted the referral and, during their investigation and the course of the trial, secured records for these years from a variety of Hong Kong banks. The records were requested and provided under an MLAT between the U.S. and Hong Kong. After the trial was completed, an international revenue agent audits the taxpayer's 2002 tax return in which the taxpayer claimed a NOL going back to the 1999 tax year. The revenue agent would have access to all of the 1999 financial records that were secured under the MLAT and introduced as evidence in the criminal proceeding.

Key Points:

- Assistance under a Mutual Legal Assistance Treaty can be requested once a criminal investigation or prosecution has been initiated.
- MLAT requests are made by the Criminal Investigation Division of the Internal Revenue Service.
- A revenue agent may be able to secure access to information/records secured under an MLAT after the criminal prosecution is completed.

Summary

We have reviewed the differences and similarities between tax treaties and Tax Information Exchange Agreements (TIEAs). We have determined that both the tax treaties and the TIEAs are vehicles by which tax administrators in different countries assist one another by furnishing information to prevent fraud or fiscal evasion. These agreements are the legal authority to exchange information. The exchange of information provisions of a TIEA are more comprehensive than those of an income tax treaty and provide for the gathering of information for criminal or civil prosecution purposes. Under TIEAs, bank secrecy laws may be broken, and bearer share information may be disclosed.

We have determined that there are five exchanges of information programs currently administered under the treaties. These are:

1. the Specific Request Exchange of Information Program;
2. the Spontaneous Exchange of Information Program;
3. the Automatic/Routine Exchanges of Information Program;
4. the Simultaneous Examination Program; and
5. the Industrywide Exchange of Information Program.

Instructions have been provided for requesting information from U.S. Possession Tax Departments.

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Glossary of Terms

Contracting States	The two countries that are party to a treaty; all treaty articles are written in terms of the contracting state and the other contracting state.
Letters of Requests	Formal written request from a court or judge in one country to the Central Authority in another country requesting assistance. Streamlined procedure provided for by the Hague Evidence Convention. A civil or commercial proceeding must be pending.
Letters Rogatory	Formal written request from a court or judge in one country to the appropriate legal authority in another country requesting assistance (production of documents and records, service of process, taking of testimony, etc.). A civil or criminal proceeding must be pending.
Mutual Legal Assistance Treaty (MLAT) Subpoena	Agreement between two countries to provide a broad range of legal assistance for criminal matters. Requests under MLATs are made by the IRS Criminal Investigation Division.
Subpoena	A court order requiring a witness to appear at a particular time and place to testify and/or produce documents in the control of the witness.
Summons	A summons enables the IRS to compel a person to appear to testify, or to produce books and records.
Tax Information Exchange Agreement (TIEA)	A TIEA is an executive agreement authorized under IRC § 274(h)(6)(C) which allows tax authorities to exchange tax information. A TIEA does NOT require ratification by the U.S. Senate.

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International Technical Training

Chapter 20

International Penalties

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 4 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide

Instructor Notes

This chapter presents in great detail all the international penalties. The instructor should present the topic with a broad stroke, as it is impossible to remember all the code sections and applications of all the penalties discussed. The exhibit section is a useful reference guide for the revenue agent to use as a tool in determining penalties in the international context.

Overview

Background

A large number of penalties have been included in the Internal Revenue Code over the years. Many of them are complicated, and the sheer number of them may lead to confusion or omission. This lesson is intended to provide you with a summary of the penalties you might have to consider imposing.

Purpose of Penalties

The purpose of the penalties discussed in this lesson is to enhance taxpayer voluntary compliance with statutory reporting, filing, and record maintenance requirements. You are guided in your decisions on impositions of penalties by the applicable statutes, regulations, and procedural instructions issued by the IRS. You should not hesitate to impose an applicable penalty when appropriate. You should refer to the Penalty Policy Statement contained in IRM (20).

On Whom Assessed

The penalties discussed in this lesson are assessed against taxpayers who are U.S. persons doing business outside the United States and foreign entities doing business in the United States. Unless otherwise indicated, the term “U.S. person” includes individuals, corporations, partnerships, estates, or trusts. (See IRC § 7701(a)).

The international penalties in this lesson are either subject to deficiency or non-deficiency procedures and are reflected as such in the chart that describes these penalties.

Note

Before the assertion of any penalty you should be aware of the statute, regulations, any exceptions, or limitations, etc. that may apply to the case at hand. Since penalty and related provisions may have changed from one tax period to another, it is very important to check the effective dates of the relevant law.

Continued on next page

Penalty Handbook IRM 20.1.9 – International Penalties

This chapter of the IRM consolidates procedures from functional IRMs into a single set of guidelines in keeping with Policy Statement P-1-18 to establish consistency in penalty administration.

This IRM should always be used in the administration of penalty assessments.

Contents

This chapter contains the following topics:

Continued on next page

Contents (continued)

Objectives

At the end of this lesson, you will be able to:

- State the key concepts of IRC § 6038 penalties.
- State the key concepts of IRC § 6038A penalties.
- State the key concepts IRC § 6662(e)(1)(B) penalties.
- Give a summary of other international penalties.
- State the conditions of reasonable cause exception.

International Penalties

Description of Penalties

The following is a brief description of the international penalty sections.

Penalty Section	Description	Deficiency Procedure Applies
6038(b)	Dollar penalty for failure to furnish information with respect to controlled foreign corporations and controlled foreign partnerships. IRC § 6038(a).	NO
6038(c)	Reduction to Foreign Tax Credit for failure to furnish information with respect to controlled foreign corporations and controlled foreign partnerships. IRC § 6038(a).	YES
6038A(d)	Monetary penalty for failure to furnish information or to maintain records by certain domestic 25 percent foreign-owned corporations. IRC § 6038A (a).	NO
6038A(e)	Non-Compliance penalty for failure to authorize an agent or failure of a reporting corporation to substantially and timely comply with a summons for records. IRC § 6038A (e).	YES
6038B(c)	Monetary penalty for failure to furnish information on transfer of property to foreign persons. IRC § 6038B (a).	NO
6038C(c)	Monetary penalty for failure to furnish information or maintain records by a foreign corporation engaged in U.S. trade or business. IRC § 6038C (a). **Penalty cannot be asserted until regulations are issued. Regulations have not been issued to date.**	NO
6038C(d)	Non-Compliance penalty for failure to authorize an agent or failure to substantially and timely comply with a summons for records by a foreign corporation engaged in a U.S. business. IRC § 6038A (e). **Penalty cannot be asserted until regulations are issued. Regulations have not been issued to date.**	YES
6039E(c)	Monetary penalty for failure to furnish information concerning resident status.	NO

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International Penalties, Continued

Description of Penalties (continued)

Penalty Section	Description	Deficiency Procedure Applies
6039F(c)	Monetary penalty for failure to furnish information for large gifts received from foreign persons after 8-20-96 AND tax consequence of receipt of such gift.	NO – 5 percent penalty YES - tax consequence of gift
6039G(c)	Failure to furnish information on individuals losing United States citizenship.	NO
6662(e) (1) (B)	Accuracy related penalty for Substantial valuation misstatement under Chapter 1 - penalty for adjustments made under IRC § 482.	YES
6662(h)	Increases the penalty under IRC § 6662(e)(1)(B) in the case of gross valuation misstatement.	YES
6679	Monetary penalty for failure to file information returns with respect to certain foreign corporations or certain foreign partnerships. IRC §§ 6035 (repealed 2004), 6046, or 6046A.	NO
6686	Failure by DISC or former DISC to file annual return and failure by a DISC, former DISC, FSC, or former FSC to supply information. IRC § 6011(c).	NO
6688	Failure to meet requirements of coordination of United States and possession individual income tax as specified. IRC § 7654.	NO
6689	Failure to notify Commissioner of redetermination of foreign tax. IRC §§ 905(c) and 404A (g) (2).	YES
6712	Failure to disclose treaty based positions. IRC § 6114.	NO

Form 5471 – Information Return of U.S. Persons With Respect to Certain Foreign Corporation

In General

The information that must be provided on Form 5471 is generally required under **IRC §§ 6038 and 6046** and their respective regulations. The penalties for failure to provide such information under IRC § section 6038 is found in that section and the penalty for IRC § 6046 is found in IRC § 6679.

Reporting / Filing Requirements IRC § 6038(a)

Under **IRC § 6038(a),** every U.S. person is required to make a complete separate annual information return (Form 5471) for each annual accounting period with respect to each foreign corporation which such person controls for an uninterrupted 30-day period during such accounting period. (Treas. Reg. § 1.6038-2).

The following foreign corporation information is required:

- Name,
- Principal place of business,
- Principal business activity,
- Country under whose laws it is incorporated and date incorporated,
- Post-1986 undistributed earnings for tax years ending after December 15, 1990,
- A balance sheet and other financial statements,
- A listing of all related transactions by the foreign corporation on a **Schedule M** attached to Form 5471, and
- A description of the various classes of outstanding stock.

The Form 5471 is filed as an attachment to the filer's income tax return (or, if applicable, partnership or exempt organization return) and is due by the due date of the filer's return (including extensions).

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Dollar Penalty for Failure to Furnish Information IRC § 6038(b)

- The U.S. person that fails to timely file complete and accurate information on the **Form 5471 and/or Schedule M** is subject to a $10,000 penalty for the year of such failure and each year the failure continues. A separate $10,000 penalty applies to each foreign corporation for which the U.S. person fails to timely file complete the required information, unless the failure was due to reasonable cause.
- If the information required is not submitted within 90 days after notification by the Service, there is an additional $10,000 penalty for every 30 days (or fraction thereof) such failure continues.
- The additional penalties shall not exceed $50,000.
- Total penalties under IRC § 6038(b) are limited to $60,000 ($10,000 initial penalty plus $50,000 continuation penalty) per form, per year.

Penalty of Reducing Foreign Tax Credit IRC § 6038(c)

IRC § 6038(c) provides for a reduction of foreign tax credit for a failure to furnish information on Form 5471. The penalty is a 10 percent reduction of the foreign income taxes available for credit under IRC §§ 901, 902, and 960, unless the failure was due to reasonable cause.

If the information required is not submitted within 90 after notification by the Service, there is an additional five percent reduction for each three-month period (or fraction thereof) such failure continues.
The limitation on this credit reduction shall not exceed the greater of:

- $10,000, or
- The income of the foreign corporation for that year.

NOTE: The amount of this penalty is reduced by the amount of the dollar penalty imposed by IRC § 6038(b) if both penalties are asserted.

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Form 5471 – Information Return of U.S. Persons With Respect to Certain Foreign Corporation, Continued

Reporting / Filing Requirements IRC § 6046

- Under **IRC § 6046**, any U.S. citizen or resident who is an officer or director of a foreign corporation must provide certain information on **Form 5471, Schedule O** to report purchases of 10 percent or more of the stock of the foreign corporation by U.S. persons. The officer or director must file Form 5471 as a Category 2 filer.
- There is a separate filing requirement under IRC § 6046 in any year where a U.S. person acquires or disposes of 10 percent or more of the stock of a foreign corporation, by vote or value. In this instance, it is the U.S. person who acquires or disposes of 10 percent or more of their interest that has the filing requirement. The U.S. shareholder must file Form 5471 as a Category 3 filer.
- This necessary information includes:
  - The name, address, and identifying number of each shareholder.
  - Whether the shareholder is acquiring or disposing of stock of the foreign corporation and the amount of the increase or decrease in ownership.
  - The date of the acquisition, disposition, or change in ownership.

- The Form 5471 and **Schedule O** shall be filed by the due date of the taxpayer's income tax return (including extensions).

Dollar Penalty for Failure to Furnish Information IRC § 6679

- A penalty may be imposed under IRC § 6679 for failure to provide information required under IRC § 6046A. This penalty is $10,000 for each failure, unless the failure was due to reasonable cause. (Treas. Reg. § 301.6679-1(a)(1)).
- In addition, if the information required is not submitted within 90 days after notification by the Service, there is an additional $10,000 penalty for every 30 days (or fraction thereof) such failure continues.
- The additional penalties shall not exceed $50,000.

Total penalties under IRC § 6679 are limited to $60,000 ($10,000 initial penalty plus $50,000 continuation penalty) per form, per year.

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Form 5471 – Information Return of U.S. Persons With Respect to Certain Foreign Corporation, Continued

Examples of Noncompliance

Taxpayers who are required to file Forms 5471 with applicable schedule(s) may be subject to penalties for filing late or incomplete forms. The taxpayer should provide the missing information or establish reasonable cause for the failure.

The most common examples of noncompliance are:

- Failing to timely file complete Forms 5471.
- Forms 5471 which indicate that required information will be furnished upon request or examination.
- Submitting one financial statement that consolidates data from two or more foreign corporations.
- Failure to provide related party transactions on Schedule M (when applicable)
- Failure to provide financial statements on controlled foreign corporations.

Summary

The requirement to file Form 5471 is based upon the information requirements of IRC §§ 6038(a) and 6046.

Penalties for failure to provide this information are triggered by IRC §§ 6038(b), 6038(c), and 6679 and attendant regulations.

Reading Assignment

- IRC § 6038(a) - Requirements (Category 4 and 5 filers).
- IRC § 6038(b) - Dollar penalty for failure to furnish information (Category 4 and 5 filers).
- IRC § 6038(c) - Penalty of reducing foreign tax credit (Category 4 and 5 filers).
- IRC § 6046 - Requirements (Category 2 and 3 filers).
- IRC § 6679 - Penalty for failure to file returns, etc., with respect to foreign corporations or foreign partnerships (Category 2 and 3 filers).
- Treasury Regulations § 1.6038-2 - Information returns required of U.S. Persons.

Form 8865 – Return of U.S. Persons With Respect to Certain Foreign Partnerships

In General

The information that must be provided on Form 8865 is generally required under **IRC §§ 6038, 6038B, and 6046A** and their respective regulations. The penalties for failure to provide such information under IRC §§ 6038 and 6038B are found in those sections and the penalty for IRC § 6046A is found in IRC § 6679.

Reporting / Filing Requirements IRC § 6038(a)

Under **IRC § 6038(a),** a U.S. person may be required to make a complete separate annual information return (Form 8865) for each annual accounting period with respect to each foreign partnership in which such person has at least a 10 percent interest during such accounting period. The regulations under IRC § 6038(a) limit the situations in which a U.S. partner must file such a return.

The following foreign partnership information is required:

- Name, address and TIN,
- Principal place of business,
- Principal business activity,
- A balance sheet and other financial statements,
- A listing of all related party transactions by the foreign partnership on a Schedule N attached to Form 8865, and
- A description of the ownership.
- A listing of interests in other partnerships in which the foreign partnership owns a 10 percent interest on Schedule A-2 and of Disregarded Entities (DE) the foreign partnership owns on Form 8858.

The Form 8865 is filed as an attachment to the filer's income tax return (or, if applicable, partnership or exempt organization return) and is due by the due date of the filer's return (including extensions).

See Treasury Regulation § 1.6038-3 for further information.

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Dollar Penalty for Failure to Furnish Information IRC § 6038(b)

The U.S. person that fails to timely file complete and accurate information on the **Form 8865 and/or Schedule N** is subject to a $10,000 penalty for the year of such failure and each year the failure continues. A separate $10,000 penalty applies to each foreign partnership for which the U.S. person fails to timely file complete the required information, unless the failure was due to reasonable cause.

If the information required is not submitted within 90 days after notification by the Service, there is an additional $10,000 penalty for every 30 days (or fraction thereof) such failure continues.

The additional penalties shall not exceed $50,000.

Total penalties under IRC § 6038(b) are limited to $60,000 ($10,000 initial penalty plus $50,000 continuation penalty) per form, per year.

Reporting / Filing Requirements IRC § 6038B

IRC § 6038B requires each U.S. person who transfers property to a foreign partnership to report the transfer when:

1. immediately after the transfer the U.S. person owns a 10 percent or more interest in the partnership, OR
2. the value of the property transferred (including all other transfers in a 12-month period ending on the date of the transfer) exceeds $100,000.

The U.S. person is required to report the transfer on **Form 8865, Schedule O.**

This necessary information includes:

- Name, address, and TIN of the transferor,
- Description of property transferred,
- Date of transfer,
- FMV on date of transfer,
- Basis in item transferred,
- Percentage of partnership interest after the transfer, and
- Names and addresses of the other partners.

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Penalty for Failure to Furnish Information IRC § 6038B

- The Form 8865 and **Schedule O** shall be filed by the due date of the taxpayer's return (including extensions).
- The penalty for failure to file Form 8865, Schedule O is 10 percent of the FMV of the asset transferred, up to a maximum of $100,000, unless the failure was due to reasonable cause.
- In addition, the U.S. person who failed to file the information under IRC § 6038B must recognize gain on the asset transferred. (IRC § 6038B(c)).
- If the failure to file Form 8865, Schedule O was due to intentional disregard, the $100,000 maximum limit does NOT apply.
- See Treasury Regulations § 1.6038B-2 for more information.

Reporting / Filing Requirements IRC § 6046A

- Under **IRC § 6046A**, any U.S. citizen or resident who has an acquisition, disposition or change in ownership interest in a foreign partnership must file **Form 8865 and attach a Schedule P** to report the change in ownership.
- This necessary information includes:
  - The name, address, and identifying number of each partner;
  - Whether the partner acquired, disposed of, or changed its direct ownership interest by 10 percent;
  - The date of the acquisition, disposition, or change in ownership;
  - Information about persons whose partnership interests are constructively owned by the taxpayer;
  - Information about the disregarded entities owned by the partnership to be reported on Form 8858; and
  - The fair market value of the interest acquired, disposed of, or changed.

- The **Form 8865 and Schedule P** shall be filed by the due date of the taxpayer's return (including extensions).
  See Treasury Regulation § 1.6046A-1 for more information.

Continued on next page

Form 8865 – Return of U.S. Persons With Respect to Certain Foreign Partnerships, Continued

Penalty – IRC § 6679

- A penalty may be imposed under IRC § 6679 for failure to provide information required under IRC § 6046A. This penalty is $10,000 for each failure, unless the failure was due to reasonable cause. (Treas. Reg. § 301.6679-1(a)(1)).
- In addition, if the information required is not submitted within 90 days after notification by the Service, there is an additional $10,000 penalty for every 30 days (or fraction thereof) such failure continues.
- The additional penalties shall not exceed $50,000.
- Total penalties under IRC § 6679 are limited to $60,000 ($10,000 initial penalty plus $50,000 continuation penalty) per form, per year.

Summary

The requirement to file Form 8865 is based upon the information requirements of IRC §§ 6038(a), 6038B, and 6046A.

Penalties for failure to provide this information are triggered by IRC §§ 6038(b), 6038B(c), and 6679 and attendant regulations.

Reading Assignment

- IRC § 6038(a) - Requirements.
- IRC § 6038(b) - Dollar penalty for failure to furnish information (Category 1 or 2 filers).
- IRC § 6038B - Notice of certain transfers to foreign persons (Category 3 filers)
- IRC § 6046A - Requirements (Category 4 filers).
- IRC § 6679 - Penalty for failure to file returns, etc., with respect to foreign corporations or foreign partnerships (Category 4 filers).
- Treasury Regulations § 1.6038-3 - Information returns required of U.S. persons.

IRC § 6038A – Information with Respect to Certain Foreign Owned Corporations

History

IRC § 6038A was added by P.L. 97-248 (TEFRA) and applies to tax years beginning after December 31, 1982.

- The current IRC § 6038A was amended in 1989.

In General

IRC § 6038A ONLY applies to a U.S. corporation that is 25 percent or more foreign owned.

Per Treas. Reg. § 1.6038A-1(b), a "reporting corporation" must:

- Furnish the information required in Treas. Reg. §1.6038A-2, including information regarding its transactions with each related party, by filing an annual information return on Form 5472, and
- Maintain records as described in Treas. Reg. §1.6038A-3.

Applicable Definitions

The definitions that follow apply to IRC § 6038A.

Reporting Corporation Treas. Reg. § 1.6038A-1(c)(1)

A **reporting corporation** is defined as:

- A domestic corporation that is at least 25 percent foreign-owned, or
- A foreign corporation engaged in a trade or business within the United States.

NOTE: After November 4, 1990, any foreign corporation engaged in a U.S. trade or business at any time during the taxable year is a reporting corporation under IRC § 6038C. IRC § 6038C subjects such foreign corporations to the same information reporting and record maintenance requirements that apply under IRC § 6038A to domestic 25 percent foreign-owned corporations and penalizes them in the same manner.

Continued on next page

IRC § 6038A – Information with Respect to Certain Foreign Owned Corporations, Continued

Reporting Corporation Treas. Reg. § 1.6038A-1(c) (1) (continued)

CAUTION: IRC § 6038C is not a self-executing section - regulations must be issued before any penalty can be asserted under this section. Regulations under IRC § 6038C have not been issued, therefore no penalty can be assessed under IRC § 6038C. There is an exception if the taxpayer destroyed records in existence on or after March 20, 1990.

25 Percent Foreign Owned Treas. Reg. § 1.6038A-1(c) (2)

A corporation is **25 percent foreign-owned** if it has at least one direct or indirect 25 percent "foreign shareholder" at any time during the taxable year.

25 Percent Foreign Shareholder Treas. Reg. § 1.6038A-1(c) (3)

A **25 percent** foreign shareholder is any foreign person who owns at least 25 percent of:

- The total voting power of all classes of stock of the corporation entitled to vote, or
- The total value of all classes of stock of the corporation.

Related Party Treas. Reg. § 1.6038A-1(d)

Related party means:

- Any direct or indirect 25 percent foreign shareholder of the reporting corporation;
- Any person who is related within the meaning of IRC §§ 267(b) or 707(b)(1) to the reporting corporation or to a 25 percent foreign shareholder of the reporting corporation, or
- Any other person who is related to the reporting corporation within the meaning of IRC § 482 and the regulations thereunder.

A "related party" does not include any corporation filing a consolidated federal income tax return with the reporting corporation.

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Reportable Transaction Treas. Reg. § 1.6038A-2(a) (2)

A **reportable transaction** is any transaction with a foreign related party of the type listed in Treas. Reg. §§ 1.6038A-2(b)(3) and (4) for which monetary or non-monetary consideration is involved. A **reportable transaction** is one that would affect the net income of the U.S. reporting corporation.

These transactions include, for example, loans, sales, purchases, rents and royalties paid and received, interest, and commission. These would be “reportable transactions” because they are included in the income or deductions of the U.S. corporation.

However, dividends paid to a foreign parent would not be included as a “reportable transaction” because dividends are paid from income after taxes.

Reporting / Filing Requirements Treas. Reg. § 1.6038A-2

A reporting corporation must timely file an annual information return on Form 5472 with respect to each related party with which it has had any reportable transactions during the taxable year.

The information required on the return includes:

- Name, address, and taxpayer identification number,
- Principal place of business,
- Nature of business,
- Country or countries in which the person is organized or incorporated, conducts business, and files an income tax return as a resident,
- Total assets of U.S. reporting corporation, and
- Nature of relationship and value of transactions between reporting corporation and related party (Form 5742 - Part IV).

The Form 5472 is filed as an attachment to the income tax return. It is due by the due date of the filer’s income tax return (including extensions). (Treas. Reg. § 1.6038A-2(d)). No Form 5472 is required to be filed in a year where there are no "reportable transactions." (Treas. Reg. § 1.6038A-2(f)(1)).

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IRC § 6038A – Information with Respect to Certain Foreign Owned Corporations, Continued

Record Maintenance Treas. Reg. § 1.6038A-3(a)(1)

A reporting corporation must keep the permanent book of account or records as required by IRC § 6001 that are sufficient to establish the correctness of the federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties.

Monetary Penalty IRC § 6038A (d)

A reporting corporation is subject to a penalty if it:

- Fails to timely file a Form 5472,
- Fails to file a substantially complete Form 5472,
- Fails to maintain records, and/or
- Fails to comply with the non-U.S. record maintenance requirements.

Amount of Penalty Initial Penalty

- The U.S. reporting corporation that fails to timely file complete and accurate information on the **Form 5472** is subject to a $10,000 penalty for the year of such failure and each year the failure continues. A separate $10,000 penalty applies to each related party with respect to which such failure occurs, unless the failure was due to reasonable cause.

NOTE: The initial penalty is applied only once to each set of transactions with a related party, even though the taxpayer may be in violation of multiple failures (failure to file, failure to maintain records, and/or failure to comply with the non-U.S. maintenance requirements.) However, after notification, the additional $10,000 penalty can be assessed for **each** failure with respect to **each** related party (Treas. Reg. § 1.6038A-4).

Continued on next page

Additional Penalties Where Failure Continues IRC § 6038A (d) (2)

- If the information required is not submitted within 90 days after notification by the Service, there is an additional $10,000 penalty for every 30 days (or fraction thereof) that each failure continues. The continuation penalty continues to accrue until the taxpayer cures the failure. There is **NO** maximum amount for the continuation penalty.
- The filing of a complete and accurate Form 5472 will stop the running of the additional penalty. A failure to maintain records may be cured by developing a record maintenance system acceptable to the Director, Field Operations.

Calculation of Monetary Penalty under IRC § 6038A (d)

Treas. Reg. § 1.6038A-4(f)

EXAMPLE:

USCO, a U.S. reporting corporation, engages in related party transactions with foreign corporation (FC) during 2005. USCO does not timely file a Form 5472 or maintain records relating to the transaction with FC.

You impose a $ 10,000 initial penalty and on January 2, 2007, mail a notice of failure to file Form 5472 to the taxpayer.

On May 15, 2007, taxpayer cures the record maintenance failure and files a Form 5472 reporting the FC transactions.

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Calculation of Monetary Penalty under IRC § 6038A (d)

Treas. Reg. § 1.6038A-4(f) (continued)

Penalty Computation

I.	Initial Penalty	$10,000
	Failure to File Form 5472	-0-
	Failure to maintain records (no additional)	$10,000
	Total	
II.	Additional for April 3 to May 3 (30 day period beyond 90 days)	
	Failure to file Form 5472	$10,000
	Failure to maintain records	10,000
	Total	$20,000
III.	Additional. penalty for May 4 to May 15 (fraction of 30-day period)	
	Failure to file Form 5472	$10,000
	Failure to maintain records	10,000
	Total	$20,000
IV	Monetary Penalties Imposed	
	Initial penalty	$10,000
	Additional for April 3 to May 3	20,000
	Additional for May 4 to May 15	20,000
	Total IRC § 6038A monetary penalties	$50,000

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Noncompliance Penalty IRC § 6038A(e)

- Under IRC § 6038A(e), if an Authorization of Agent is not provided by the foreign related party within 30 days of request by the Service, or if the reporting corporation fails to produce records described in IRC § 6038A(e)(3), then a Noncompliance Penalty may be imposed. The Noncompliance Penalty is an adjustment to the reporting corporation's cost of goods sold or deductions with respect to related party transactions based on the sole discretion of the IRS from its own knowledge or other information.
- The IRS may disregard any information or material that was submitted to the IRS where it deems such information or material to be insufficiently probative of the relevant facts.
- The fact that information is later presented to a reviewing court that was not available to the IRS will not in itself permit the court to overturn the IRS's determination.

NOTE: There is no reasonable cause exception for failure to timely provide the authorization of agent.

CAUTION: All proposed noncompliance penalty adjustments under IRC § 6038A (e)(3) must be reviewed by the International Technical Advisor (ITA) for International Penalties. It is the duty of the ITA to inform the Office of Associate Chief Counsel (International) about the case **before** issuance of the notice to the taxpayer. Specific procedures pertaining to IRC § 6038A cases are contained in the IRM.

Authorization of Agent IRC § 6038A (e)

The Service has no jurisdiction over records located outside of the United States. When a U.S. reporting corporation engages in reportable transactions with a foreign related party certain records pertaining to those transactions may be located outside of the United States. The Service can request the reporting corporation to act as a limited agent for the foreign related party for purposes of IRS summons procedures under IRC §§ 7602, 7603, and 7604. This gives the Service the power to request the information located outside of the United States. The Authorization of Agent must be signed within 30 days of a request by the Service.

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Legal Effect of Authorization of Agent

- Agent for accepting service of process.
- Agent for purposes of commencing judicial proceedings.

Failure to Comply with Summons IRC § 6038A (e)

Where the IRS issues a summons to produce records or testimony under IRC § 6038A to a reporting corporation for purposes of determining the correct treatment under the Internal Revenue Code of any transaction between the reporting corporation and a foreign related party, the noncompliance provisions of IRC § 6038A(e) may be applied if:

- The reporting corporation does not substantially comply in a timely manner with such summons, and
- Such summons is not quashed by a U.S. district court and not determined to be invalid in a proceeding begun under IRC § 7604(b) to enforce such summons, and
- The IRS has sent by certified or registered mail a notice to such reporting corporation that it has not substantially complied. (IRC § 6038A (e)(2)).

If the summons is quashed because the reporting corporation failed to maintain (or cause another to maintain) records as required by IRC § 6038A and thereby is not able to provide the records requested in the summons, the IRS may still apply the noncompliance penalty under IRC § 6038A(e).

NOTE: If the reporting corporation brings an action to quash or review the IRS determination, the running of any period of limitations on assessment and collection of tax and criminal prosecution for any affected tax year shall be suspended for the time during which such proceeding, and appeals therein, are pending **plus** 90 days after a final determination in such proceeding. (IRC § 6038A(e)(4)(D)).

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Relief Provisions

Under certain circumstances, a taxpayer is relieved from the Authorization of Agent and record keeping requirements of IRC § 6038A (e). These circumstances include:

- Small corporation exception under Treas. Reg. § 1.6038A-1(h), and
- *De minimis* failure relief under Treas. Reg. § 1.6038A-6(d).

NOTE: There is NO small corporation exception or de minimis provision for relief from filing Form 5472.

Small Corporation Exception Treas. Reg. § 1.6038A-1(h)

A small corporation is one with less than $10,000,000 in U.S. gross receipts for a taxable year. U.S. gross receipts include all amounts received or accrued to the extent that such amounts are taken into account for the determination and computation of the gross income of the corporation. If a taxpayer falls under the small corporation exception, they will not be required to provide an Authorization of Agent.

HOWEVER: The small corporation exception does NOT apply to reporting requirements for Form 5472 (Treas. Reg. § 1.6038A-2) OR to the record maintenance requirements of IRC § 6001.

De Minimis Failure Relief Treas. Reg. § 1.6038A-6(d)

The IRS may choose not to apply the noncompliance penalty where the reporting corporation's failure to comply with the requirement to furnish information pursuant to IRC § 6038A(e)(2) is *de minimis*. For example, where a particular document or group of documents is not furnished upon request or summons, the Director of Field Operations (DFO) (at his/her sole discretion) may choose not to apply the noncompliance penalty if he/she deems the document or documents not to have significant or sufficient value in the determination of the correctness of the tax treatment of the related party transaction.

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IRC § 6038A – Information with Respect to Certain Foreign Owned Corporations, Continued

Standards of Judicial Review

Burden of proof on the taxpayer by clear and convincing evidence.

The Non-Compliance Penalty cannot be overturned by a court on the basis that it diverges from actual cost, or on the basis that it does not clearly reflect income. An adjustment may be overturned only if an improper motive is shown, or it is clearly erroneous, based on the information within the possession of the IRS.

ASAT, Inc. v. Commissioner, 101 T.C. No. 11 (1997) held that the IRS did not abuse its discretion in adjusting taxpayer's costs of goods sold and net operating losses under IRC § 6038A(e)(3).

Summary

The requirement to file Form 5472 is due to information required by IRC § 6038A. This same Code section triggers the penalties for failure to file Form 5472 or failure to maintain required records.

REGULATION	DESCRIPTION
1.6038A-1	General requirements and definitions.
1.6038A-2	Information to be submitted and the filing of the required return.
1.6038A-3	Record maintenance.
1.6038A-4	Monetary penalty.
1.6038A-5	Authorization of agent.
1.6038A-6	Failure to furnish information.
1.6038A-7	Noncompliance Penalty for failure to authorize agent or to substantially comply with summons.

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Reading Assignment

- IRC § 6038A (a) - Requirement.
- IRC § 6038A (b) - Required Information.
- IRC § 6038A (c) - Definitions.
- IRC § 6038A (d) - Penalty for Failure to Furnish Information or Maintain Records.
- IRC § 6038A (e) - Enforcement of Requests for Certain Records.
- IRC § 6038C - Information with respect to Foreign Corporations Engaged in U.S. Trade or Business.

IRC § 6662 – Imposition of Accuracy Related Penalty on Underpayments

Background

IRC § 6662 imposes an accuracy-related penalty in certain situations. Under IRC § 6662(a), the accuracy-related penalty is 20 percent of the portion of the underpayment attributable to any one or more of the misconducts listed in IRC § 6662(b). IRC § 6664(a) defines underpayment as the excess of the amount of tax required to be shown on the return for a taxable year over the amount of the tax imposed which is shown on the return, reduced by any rebate.

This lesson will cover the misconducts described in IRC § 6662(b) that trigger IRC § 6662, namely an underpayment attributable to "any substantial valuation misstatement under Chapter 1" under IRC § 6662(b) (3).

IRC § 6662(e) extends the 20 percent penalty for "substantial valuation misstatement under Chapter 1" to certain adjustments made under IRC § 482.

- **Transactional Penalty** – Raised when the Service determines that the price for any property or services (or for the use of property) claimed on a tax return is 200 percent or more (or 50 percent or less) than the amount determined to be correct under IRC § 482.

OR

- **Net Adjustment Penalty** – Raised when the Service determines that the "net IRC § 482 transfer price adjustment" for a taxable year exceeds the lesser of:
  - $ 5,000,000, or
  - 10 percent of the taxpayer's gross receipts.

The net IRC § 482 transfer price adjustment under IRC § 6662(e)(3) is defined as "the net increase in taxable income for a taxable year resulting from adjustments under IRC § 482 in the price of any property or services (or for the use of property"). Regulations under IRC § 6662(e) were issued and effective February 9, 1996 (T.D. 8656).

IRC § 6662(h) increases the 20 percent penalty to 40 percent in the case of "gross valuation misstatements."

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Reason for Enactment

- Historically, International Examiners (IEs), have encountered difficulties in IRC § 482 transfer price examinations. IEs would issue IDRs requesting information regarding transfer pricing policies and methodologies and the taxpayer's response would typically be minimal and generally submitted after substantial delays.
- Prior to 1990, taxpayers were not required to keep any documentation under the IRC § 482 regulations regarding the transfer pricing policies and methodologies. During an audit, the taxpayer would look for comparables and attempt to justify the transfer price after the fact. This approach generally complicated and prolonged the audit.
- Treasury stated the reason for enactment of the IRC § 6662 regulations (T.D. 8519, 1994-1 CB 298) as follows: to encourage ". . . a taxpayer engaged in related party transactions to prepare a factual and economic analysis based on reasonably available related party and third party market data that substantiates the price chosen, and to maintain appropriate documentation of that analysis."

Treas. Reg § 1.6662-6(d), in a nut-shell, states that in order to avoid a <u>Net Adjustment</u> transfer pricing penalty, a taxpayer must:

- Reasonably select and apply a transfer pricing methodology that results in an arm's length return;
- Maintain certain records as specified in the regulations. These records must be in existence at the time of filing the return; and
- Provide the documentation to the IRS within 30 days of a request for it.

In order to avoid a <u>Transactional Penalty</u>, the taxpayer must establish Reasonable Cause per IRC § 6664(c).

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IRC § 6662 – Imposition of Accuracy Related Penalty on Underpayments, Continued

Amount of Penalty IRC § 6662(e)

The penalty is equal to 20 percent of the underpayment of tax attributable to the “substantial valuation misstatement.” Under IRC § 6662(e)(1)(B), the penalty applies to the tax due on 482 adjustments.

Pursuant to IRC § 6662(h), the penalty is increased to 40 percent to the extent that a portion of the underpayment is attributable to one or more “gross valuation misstatement.”

Examples of IRC § 6662(e)(1)(B) Penalties

The following examples explain circumstances presented in the regulations which evaluate whether a taxpayer's IRC § 482 transactions meet or do not meet the threshold for applying the net adjustment or transactional penalty. That threshold determination is only the first step in determining if the penalty is applicable.

Once the threshold has been met, you must then determine if the taxpayer will be permitted to exclude any amounts under Treas. Reg. § 1.6662-6(d) for the net adjustment penalty or IRC § 6664(c) and accompanying regulations for the transactional penalty.

Example # 1 – Transactional Penalty

Facts:

- USCO (a domestic parent) owns 100 percent of controlled foreign corporation ("CFC," a foreign entity)
- USCO sells a machine to CFC for $50,000
- The arm’s length price for the machine is $100,000
- Upon audit, you adjust the price to $100,000

The price on the return of $50,000 is 50 percent or less than the amount determined to be correct ($100,000). Thus, USCO meets the threshold for the imposition of the transactional penalty under IRC § 6662(e)(1)(B)(i).

Comment: In this and the next example, USCO might be subject to the Net Adjustment Penalty depending upon additional facts.

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Example # 1 – Transactional Penalty (continued)

Then you must determine whether the taxpayer has met the reasonable cause and good faith exception under IRC § 6664(c) and Treas. Reg. § 1.6664-4.

Example # 2 – Transactional Penalty

Facts:

- USCO (a domestic parent) owns 100 percent of CFC (a foreign entity)
- CFC sells a machine to USCO for $175,000
- The arm's length price for the machine is $100,000
- Upon audit, you adjust the price to $100,000

The price on the return ($175,000) is not 200 percent or more than the amount determined to be correct ($100,000). Thus, USCO does NOT meet the threshold for the transactional penalty. Since the threshold has not been met, the penalty is not applicable.

Example # 3 – Net Adjustment Penalty Treas. Reg. § 1.6662-6(c) (7) Ex. 1

Facts:

The IRS makes the following adjustments under IRC § 482 for a taxable year:

• Increase in income due to an increase in royalty payments	$2,000,000
• Increase in income due to a decrease in profit margin of a related buyer	2,500,000
• Increase in income due to a decrease in the cost plus mark-up of a related seller	2,000,000
Total IRC § 482 adjustments	$ 6,500,000

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Example # 3 – Net Adjustment Penalty Treas. Reg. § 1.6662-6(c) (7) Ex. 1 (continued)

The net IRC § 482 adjustments ($6,500,000) are greater than $5,000,000. Therefore, there is a substantial valuation misstatement and the threshold has been met. Since the adjustment exceeds $5,000,000, it is immaterial whether it also exceeds 10 percent of the taxpayer's gross receipts. You will now have to determine if any amounts should be excluded if the taxpayer meets the documentation requirements of Treas. Reg. § 1.6662-6(d).

Example # 4 – Net Adjustment Penalty Treas. Reg. § 1.6662-6(c)(7) Ex. 2

Facts:

The IRS makes the following adjustments under IRC § 482 for a taxable year:

• Increase in income due to an increase in royalty payments	$11,000,000
• Increase in income due to a decrease in profit margin of a related buyer	2,000,000
• Setoff under Treas. Reg. § 1.482-1(g)(4)	(9,000,000)
Total IRC § 482 adjustments	$ 4,000,000

The taxpayer has gross receipts of $60,000,000.

The net IRC § 482 adjustment ($4,000,000) is less than the lesser of:

- $5,000,000, or
- 10 percent of the gross receipts ($60,000,000 x 10% = $6,000,000.)

Since the threshold for the Net Adjustment Penalty has not been met, no penalty would apply.

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Consolidated Returns Treas. Reg. § 1.6662-6(a) (2)

Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer's books and records. In the case of a taxpayer who is a member of a consolidated group, the above rule applies to the consolidated income tax return of the group.

Example # 5 – Net Adjustment Penalty – (Consolidated Return) Treas. Reg. § 1.6662-6(c)(7) Ex. 3

The IRS makes the following IRC § 482 adjustments to the income of an affiliated group that files a consolidated return:

• Attributable to Member A	$1,500,000
• Attributable to Member B	1,000,000
• Attributable to Member C	<u>2,000,000</u>
Total IRC § 482 adjustments	$4,500,000

Members A, B, and C have gross receipts of $20,000,000, $12,000,000, and $11,000,000, respectively. Thus the total gross receipts are $43,000,000.

The net IRC § 482 adjustment ($4,500,000) is greater than the lesser of:

- $5,000,000, or
- 10 percent of the gross receipts ($43,000,000 x 10% = $4,300,000.)

Therefore, the threshold for the Net Adjustment Penalty has been met.

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Relief from Transactional Penalty Treas. Reg. § 1.6662-6(b) (3)

Pursuant to IRC § 6664(c), the **Transactional Penalty** will not be imposed on any underpayment if:

- It was due to reasonable cause, and the taxpayer acted in good faith.
- A taxpayer has relied on professional analysis in determining its transfer pricing. Whether the professional is an employee of or related to the taxpayer is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice.

See regulations under Treas. Reg. § 1.6664-4 for further explanation of the reasonable cause and good faith requirement.

Adjustments Exclude in Determining Net Adjustment Penalty – IRC § 6662(e) (3) (B)

For determining whether the $5,000,000 or 10 percent of gross receipts threshold has been met for the purpose of "the net IRC § 482 transfer price adjustment," an amount is excluded in computing the net increase in taxable income resulting from an IRC § 482 adjustment in three different situations.

These are:

- IRC § 6662(e)(3)(B)(i) – Taxpayer determined a transfer price in accordance with a specific pricing method as set forth in the regulations under IRC § 482; taxpayer's use of such method was reasonable, and documentation requirements are met.
- IRC § 6662(e)(3)(B)(ii) – Taxpayer determined a transfer price not in accordance with a specific pricing method as set forth in the regulations under IRC § 482. Such transfer price was likely to result in a price that clearly reflects income and documentation requirements are met.
- IRC § 6662(e)(3)(B)(iii) – Transactions are solely between foreign corporations, unless such transaction affects the determination of income from U.S. sources or taxable income effectively connected with a U.S. trade or business.

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Amounts Excluded from Net IRC § 482 Adjustments Treas. Reg. § 1.6662-6(d)(2)

The most common reason to have an amount excluded from the penalty computation is to meet the three requirements of IRC § 6662(e)(3)(B)(i):

- **Specific Method Requirement** - Taxpayer establishes that the transfer price was determined in accordance with a specific pricing method as set forth in the regulations under IRC § 482, and taxpayer's use of such method was reasonable.
- **Documentation Requirement** - Taxpayer has documentation (**which was in existence as of the time of filing the return**) establishing that the price under the method chosen was reasonable.
- **30-Day Requirement** - Taxpayer turns over to the IRS all documents within 30 days of a request for such documents.

The above are general rules specified by the Code. The regulations contain the ten required items that must be addressed in the documentation.

If the taxpayer uses an unspecified method, read Treas. Reg. §1.6662-6(d)(3) for exclusion requirements.

Example

The IRS makes the following IRC § 482 adjustments:

• Increase in gross income because of an increase in royalties	$ 9,000,000
• Increase in gross income due to price paid for related party sales	2,000,000
Total IRC § 482 adjustments	$11,000,000

The taxpayer's Gross Receipts are $75,000,000. If no additional facts exist, then the threshold for the Net Adjustment Penalty has been met because the IRC § 482 adjustments ($11,000,000) is greater than the lesser of:

- $5,000,000 OR
- 10 percent of Gross Receipts ($7,500,000).

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Example (continued)

Additional Facts: The taxpayer establishes that for the Royalty adjustment it:

- applied a transfer pricing method specified in IRC § 482; the selection and application of the method was reasonable,
- documented the pricing analysis, and
- turned over the documentation to the IRS within 30 days of a request.

Taking into account the additional facts, the $9,000,000 will be excluded from the calculation of the net IRC § 482 adjustment.

Because the remaining net IRC § 482 adjustment is only $2,000,000 (which does not meet the threshold for the Net Adjustment Penalty), no penalty per IRC § 6662(e) is applicable.

Reason for Contemporaneous Documentation

The IRS stated the reason for contemporaneous documentation in a Notice of Proposed Rule Making (INTL-21-91, 1993-1 CB 846) as follows:

"The experience of Internal Revenue Service international examiners has been that the majority of taxpayers are unable to provide an explanation of how their intercompany pricing was established. This may account in large part for the fact that in many cases international examiners' access to a corporation's transfer pricing information is delayed or denied. Thus the taxpayer, not having structured the transaction with any comparable in mind, seeks to defend its position by finding whatever transaction or method gives rise to a result that most closely approximates the controlled transaction result initially reported. Thus, the lack of contemporaneous documentation of how a controlled transaction result was determined increases the time spent and expense incurred by both the taxpayer and the IRS in determining whether that result was arm's length."

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Specific Method Requirement – Treas. Reg. § 1.6662-6(d)(2)(ii)

This requirement is met if the taxpayer selects and applies a specific method in a reasonable manner.

Factors relevant to determining whether taxpayer's conclusion was reasonable include:

- Experience and knowledge of taxpayer.
- Extent to which reliable information was available and the information was analyzed in a reasonable manner. Taxpayer must use the most current reliable information that is available before the end of the taxable year in question.
- Extent to which taxpayer followed the regulations under IRC § 482 in applying the method.
- Extent to which taxpayer reasonably relied on a study performed by a professional qualified to conduct such study. Such reliance is reasonable only if the taxpayer disclosed to the professional all relevant information regarding the controlled transactions at issue.
- Extent to which the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from the uncontrolled comparables in cases where the taxpayer has determined an arm's length result by using more than one uncontrolled comparable.
- Extent to which a taxpayer relied on a transfer price methodology developed and applied pursuant to an advance pricing agreement for a prior taxable year or specifically approved by the IRS pursuant to a transfer pricing audit of the transactions at issue for a prior taxable year.
- Size of a net transfer pricing adjustment compared to the controlled transaction out of which the adjustment arose.

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IRC § 6662 – Imposition of Accuracy Related Penalty on Underpayments, Continued

Documentation Treas. Reg. § 1.6662-6(d)(2)(iii)

The documentation requirement is met if the taxpayer:

- Maintains sufficient documentation to establish that the taxpayer reasonably concluded that the method used provided the most reliable measure of arm's length result under the principles of the best method rule in Treas. Reg. § 1.482-1(c),

AND

- Provides that documentation to the IRS within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates. Generally, with the exception of a summary of the relevant data and an index to the principal and background documentation requirements under Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(9) and (10), the documentation must be in existence when the return is filed.

The required documentation is divided into the following two categories:

- Principal documents, and
- Background documents.

Principal Documents Treas. Reg. § 1.6662-6(d) (2) (iii)(B)

These principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer.

The documentation **MUST** include the following:

- Overview of the taxpayer's business, including an analysis of the legal and economic factors that affect the pricing of its property or services.
- Description of the taxpayer's structure (including an organizational chart) covering all related parties engaged in transactions potentially relevant under IRC § 482, including foreign affiliates whose transactions, directly or indirectly affect the pricing of property or services in the United States.

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IRC § 6662 – Imposition of Accuracy Related Penalty on Underpayments, Continued

Principal Documents Treas. Reg. § 1.6662-6(d) (2) (iii) (B) (continued)

- Any documentation explicitly required by the regulations under IRC § 482 (Cost Sharing documentation - etc.).
- Description of the method selected and an explanation why it was selected.
- Description of the alternative methods that were considered and an explanation of why they were not selected.
- Description of the controlled transaction (including the terms of sale) and any internal data used to analyze those transactions.
- Description of the comparables that were used, how these comparables were evaluated, and if any adjustments were made.
- An explanation of the economic analysis and projections relied upon in developing the method. For example, if a profit split method is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split.
- Description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return which would help determine if the taxpayer selected and applied a specified method in a reasonable manner.
- A general index of the principal and background documents and a description of the record keeping system used for cataloging and accessing those documents.

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Background Documents Treas. Reg. § 1.6662-6(d) (2) (iii) (C)

The assumptions, conclusions, and positions contained in principal documents ordinarily will be based on, and supported by, additional background documents.

These documents include items listed in Treas. Reg. § 1.6038A-3(c), such as:

- Original entry books and transaction records,
- Pricing documents,
- Foreign country and third party filings, and
- Ownership and capital structure records.

NOTE: Not every document described in Treas. Reg. § 1.6038A-3(c) will be relevant.

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40 Percent Penalty – Gross Valuation Misstatement IRC § 6662(h)

You already know that in the case of a substantial valuation misstatement, the taxpayer may be subject to a 20 percent penalty, but the penalty is increased to 40 percent in the case of a <u>gros</u>s valuation misstatement. The same rules that apply to the substantial valuation misstatement penalty apply to the gross valuation misstatement penalty. However, there is an increased threshold for the gross valuation misstatement penalty to apply.

- <u>Transactional Penalty</u> - The price for any property or services (or the use of property) claimed on a tax return is 400 percent or more (or 25 percent or less) than the amount determined to be correct under IRC § 482 (transactional penalty)

OR

- <u>Net Adjustment Penalty</u> - The net IRC § 482 transfer price adjustment for a taxable year exceeds the <u>lesser</u> of:
  - $20,000,000, or
  - 20 percent of the taxpayer's gross receipts.

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IRS Examinations under IRC § 6662(e) (1) (B)

- At the start of any examination where a potential IRC § 482 adjustment exists, your initial IDRs must request the documentation required by Treas. Reg. § 1.6662-6(d). The taxpayer should respond within 30 days to avoid the IRC § 6662(e) penalties.
- Once you have the documentation, you should closely examine it and follow up with appropriate questions and consult with the appropriate specialists within the IRS, such as economists, engineers, Counsel, etc.
- You should also request copies of all correspondence, documentation, etc. prepared during the transfer price study. This will give you an idea of the process involved in arriving at the final transfer price used by taxpayer on its return.
- If necessary, you may request the background documentation separately.

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Summary

The following is a summary of IRC § 6662(e) penalties:

Term	Description
Purpose of penalty	• Encourage taxpayers to document their transfer pricing transactions and provide such documentation to the IRS.
Determination if penalty is applicable	• Compare results reported on tax return (or amended return if filed prior to contact by IRS) to result determined to be the correct transfer price.
Types of Penalties	o Transactional Penalty. o Net Adjustment Penalty.
Transactional Penalty	• 20% - If result reported is 200% or more (or 50% or less) of the correct transfer price. • 40% - If result reported is 400% or more (or 25% or less) of the correct transfer price. There is no penalty of reasonable cause and good faith requirements of IRC § 6664(c) are met.
Net Adjustment Penalty	• 20% - If adjustment is greater than the lesser of: o $5,000,000, or o 10% of gross receipts. • 40% - If adjustment is greater than the lesser of: o $20,000,000, or o 20% of gross receipts.
Exclusions to Net Adjustment Penalty	• IRC § 6662(e)(3)(B)(i) – Specified Method: Taxpayer determined transfer price in accordance with a specific pricing method as set forth in the 482 regulations, the use of the method was reasonable, and documentation requirements are met. • IRC § 6662(e)(3)(B)(ii) – Unspecified Method: Taxpayer determined a transfer price not in accordance with a specific pricing method as set forth in the 482 regulations the transfer price is likely to clearly reflect income, and documentation requirements are met. • IRC § 6662(e)(3)(B)(iii) – Transactions solely between foreign corporations (with certain exceptions).
Reasonableness Factors	• Experience and knowledge of taxpayer. • Extent to which reliable data were available and the data were analyzed in a reasonable manner. Taxpayer must use the most current reliable data that are available before the end of the taxable year in question. • Extent to which taxpayer followed the regulations under IRC § 482 in applying the method. • Extent to which taxpayer reasonably relied on a study performed by a professional qualified to conduct the study. Such reliance is reasonable only if the taxpayer disclosed to the professional all relevant information regarding the controlled transactions at issue.

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Summary (continued)

Term	Description
Reasonableness Factors (continued)	• Extent to which the taxpayer arbitrarily selected a result that corresponds to an extreme point in a range of results derived from the uncontrolled comparables. • Extent of reliance on APA or prior transfer pricing audit.
Documentation	• Principal documents, and • Background documents.
Principal Documentation	• Overview of the taxpayer's business, including an analysis of the legal and economic factors that affect the pricing of its property or services. • Description of the taxpayer's structure (including an organizational chart) covering all related parties engaged in transactions potentially relevant under IRC § 482, including foreign affiliates. • Any documentation explicitly required by the IRC § 482 regulations. • Description of the method selected and an explanation why it was selected. • Description of the alternative methods that were considered and an explanation of why they were not selected. • Description of the controlled transaction (including the terms of sale) and any internal data used to analyze those transactions. • Description of the comparables that were used, how they were evaluated, and what (if any) adjustments were made. • An explanation of the economic analysis and projections relied upon in developing the method. • Description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if the taxpayer selected and applied a specified method in a reasonable manner. • A general index of the principal and background documents and a description of the record keeping system used for cataloging and accessing those documents.
Background Documents	Any documents that are necessary to establish that the taxpayer's method was selected and applied in a way that provided the most reasonable measure of an arm's length result. These documents can include any documents listed in Treas. Reg. § 1.6038A-3(c), such as: • Original entry books and transaction records. • Pricing documents. • Foreign country and third party filings. • Ownership and capital structure records.

Other Penalties

In General

The following few paragraphs will give a brief overview of several other penalty sections of the Code that might be applied to areas seen in the international enforcement program.

IRC § 6038B

IRC § 6038B provides for a penalty for failure to provide information by a U.S. person who transfers property to a foreign corporation in an exchange under IRC §§ 332, 351, 354, 355, 356, or 361, or who makes a liquidating distribution as described in IRC § 336 to a foreign person, as well as to U.S. persons who transfer property to foreign partnerships (as described elsewhere in this lesson).

With respect to transfers to foreign corporations, the U.S. person is required to file information relating to such exchange or distribution as provided by the regulations. See Treas. Reg. § 1.6038B-1 and 1T(a). A taxpayer meets these requirements by timely filing a **Form 926** and attachments with the transferor's federal income tax return for the tax year of the transfer, which:

- Identifies both the transferor and transferee.
- Describes the property transferred, as well as the transfer in general.
- Indicates the amount of consideration received.
- Discloses information relating to nonrecognition transfers.

The Form 926 shall be filed by the due date of the taxpayer's return (including extensions).

The penalty for failure to file **Form 926** is 10 percent of the FMV of the asset transferred, up to a maximum of $100,000, unless the failure was due to reasonable cause.

If the failure to file Form 926 was due to intentional disregard, the $100,000 maximum limit does NOT apply.

See Treasury Regulation § 1.6038B-2 for more information.

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IRC § 6689

IRC § 6689 provides for the imposition of a penalty for failure to notify the Commissioner of a redetermination of foreign income taxes, unless due to reasonable cause.

A foreign tax redetermination means any redetermination for which a notice is required under **IRC § 905(c).**

The penalty provided by this section equals:

- 5 percent of the deficiency, if the failure is for not more than one month,

PLUS

- An additional five percent for each month (or fraction thereof), not to exceed 25 percent of the deficiency while the failure continues.

When a taxpayer has taken a tax credit for foreign income taxes accrued or a proportionate share thereof (**Form 1118 or 1116**, if required), then under **IRC § 905(c)** the taxpayer must notify the Commissioner if:

- The amount that is actually paid is not the same as the amount of the credit claimed on the taxpayer's return.
- The tax paid or accrued which generated the credit is refunded in whole or in part.

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IRC § 6039F

IRC § 6039F generally requires U.S. persons receiving large gifts from a foreign person to report information as prescribed by the Secretary. A U.S. person is required to report the receipt of gifts from:

- Foreign corporations and foreign partnerships if the aggregate amount of the gifts from all such entities exceed $10,000 during the taxable year, and
- A nonresident alien or foreign estate if the aggregate amount of gifts from that nonresident alien or foreign estate exceeds $100,000.

Reporting under IRC § 6039F is made by filing **Form 3520** on an annual basis for the year the gift was received. IRC § 6039F is effective for amounts received after August 20, 1996, for tax years ending after such date.

IRC § 6039F(c) provides for a penalty equal to five percent of the value of the gift for each month in which the gift is not reported (not to exceed 25 percent). It also provides that, if the U. S. person fails to file the Form 3520, the tax consequences of the receipt of such gift may be determined by the Secretary. These penalties will not apply if failure to file is due to reasonable cause and not willful neglect.

For further information on the reporting requirements under IRC § 6039F, see Notice 97-34, 1997-1 C.B. 422.

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IRC § 6039G

IRC § 6039G generally requires any individual who loses U.S. citizenship (within the meaning of IRC § 877(a)) on or after February 6, 1995, and long-term residents who cease to be taxed as a resident (within the meaning of IRC § 877(e)(1)) on or after February 6, 1995, to provide a statement as required by that section.

The information to be provided includes:

- Taxpayer's TIN,
- Mailing address of taxpayer's principal foreign residence,
- Foreign country in which taxpayer resides, and
- Foreign country in which taxpayer is a citizen,
- In certain cases, information detailing taxpayer's assets and liabilities, and
- Other information as the Secretary may prescribe.

See Notice 97-19, 1997-1 CB 394, sec. ix.

The statement shall be filed not later than the earliest date of expatriation acts listed in IRC § 6039G(c) and provided to the person or court referenced in that section who is responsible for providing information relating to the loss of U.S. citizenship to the Secretary.

Every calendar quarter, the Secretary publishes in the Federal Register the names of taxpayers for whom such information has been provided.

Failure to timely provide such statement as required by IRC § 6039G subjects the taxpayer to a penalty, for each year (of the 10-year period beginning on the date of the loss of U.S. citizenship) during any portion of which such failure continues, to the greater of:

- Five percent of the tax required to be paid under IRC § 877 for the taxable year ending during such year, or
- $1,000, unless reasonable cause is established.

Long-term permanent residents may provide such statement with their income tax returns for the taxable year during which the expatriation act occurs.

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IRC § 6677

Under IRC § 6677, a penalty generally applies if, under **IRC § 6048**, information returns with respect to certain foreign trusts are not timely filed or if the information is incomplete or incorrect.

IRC § 6048 requires:

- U.S. persons to report certain transactions and events involving foreign trusts.
- U.S. owners of foreign trusts to ensure that the foreign trust files an information return setting forth, among other things, a complete accounting of all trust activities.
- U.S. persons receiving distributions from a foreign trust to report information about the distribution and other information as the Secretary may prescribe.

All of the reporting requirements under IRC § 6048 are reportable on **Form 3520** for a year in which there was a reportable event, and **Form 3520A** - an annual form to report information on the foreign trust.

Generally, the penalty for failure to file Form 3520 is:

- Thirty-five (35) percent of the gross value of any property (the gross reportable amount) transferred to a foreign trust for failure by a U.S. transferor to report a reportable transfer occurring after August 20, 1996;
- Thirty-five (35) percent of the gross amount of the distributions (the gross reportable amount) received from a foreign trust for failure by a U.S. person to report receipt of the distribution, which distribution occurred after August 20, 1996.

Generally, the penalty for failure to file Form 3520A is:

- Five percent of the gross value of the portion of a foreign trust's assets treated as owned by a U.S. person (the gross reportable amount) if the trust fails to file Form 3520A (the required annual reports on trust activities and income) for taxable years after December 31, 1995;

Continued on next page

IRC § 6677 (continued)

Additional penalties may be imposed if noncompliance continues after the IRS mails a notice of failure to comply with required reporting, but this additional penalty may not exceed the gross reportable amount. No penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause. The fact that a foreign jurisdiction would impose civil or criminal penalties for disclosure of required information does not constitute reasonable cause.

For further information on the reporting requirements under IRC § 6048, see Notice 97-34, 1997-1 C.B. 422, and Notice 98-30, 1998-17 IRB 38.

Treaty-Based Return Positions IRC § 6712

IRC § 6712 provides a penalty for failure to comply with the provisions of **IRC § 6114** and applies to returns due (without extensions) after 1988.

IRC § 6114 generally requires a taxpayer who takes a position that any treaty of the U.S. overrules or modifies any provision of the IRC to disclose this position. A taxpayer meets the disclosure requirement by attaching **Form 8833** (Treaty-Based Return Position Disclosure Under IRC §§ 6114(b) or 7701(b)) or a statement to the appropriate return in the format outlined in Treas. Reg. § 301.6114-1(d).

This regulation requires disclosure of the following information signed under penalties of perjury:

- Taxpayer's name, TIN or EIN,
- Name and address of payor of income,
- Statement of citizenship or residency, and
- Statement of facts regarding each separate position taken.

NOTE: In certain circumstances, a taxpayer may be able to aggregate similar types of income as a single payment or income item for disclosure purposes. (See Treas. Reg. § 301.6114-1(d)(4)).

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Treaty-Based Return Positions IRC § 6712 (continued)

A return position is not a treaty-based return position under IRC § 6114 in the instance where taxpayer's conclusion (that no reporting is required) has a substantial probability of successful defense, if challenged. (See examples in Treas. Reg. § 301.6114-1(a)(3)). Also, the Secretary has waived this reporting requirement for certain treaty-based positions listed in Treas. Reg. § 301.6114-1(c).

If taxpayer has failed in a material way to disclose a treaty-based return position under IRC § 6114, the penalty imposed under IRC § 6712 for **each** separate treaty-based position taken and not properly disclosed is:

- For C corporations, $10,000, and
- For all other taxpayer, $1,000.

The IRC § 6712 penalty may be waived by the IRS if the taxpayer affirmatively shows that the failure to disclose the required information is not due to willful neglect. (IRC § 6712(b)). The affirmative showing is made in the form of a written statement setting forth the relevant facts and signed under penalties of perjury. (See Treas. Reg. § 301.6712-1(b)).

Returns Relating to Cash Received in a Trade or Business IRC § 6050I

Any person who, in the course of its trade or business, receives more than $10,000 in cash (including foreign currency) in a transaction (or two or more related transactions) must report the transaction to the IRS on Form 8300 by the 15th day after the date the cash is received. (Treas. Reg. § 1.6050I-1(e)).

Individuals and organizations that are required to file Form 8300 must also provide an annual written statement to each person involved in such transaction.

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Failure to File Correct Information Returns IRC § 6721

Penalties are imposed in the case of a failure by a person to:

- File an information return with the Secretary on or before the required filing date, and
- Include all of the information required to be shown on the return or the inclusion of incorrect information.

The amount of the penalty is $50 for each return not filed, but the total amount of all such failures cannot exceed $250,000 during any calendar year for such person.

NOTE: In some cases, lower limitations and exceptions may apply.

Definition of "Person" IRC § 7343

The term " person" as used in IRC §§ 7203 and 7210 is not restricted to taxpayers, but includes any officer or employee of a corporation or a member or employee of a partnership who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Criminal Penalty for Willful Failure to File IRC § 7203

A person who willfully fails to file a return, keep any records, supply any information, or pay tax is, in addition to other penalties, be guilty of a misdemeanor (felony if IRC § 6050I applies).

Upon conviction thereof, such person shall be fined not more than $25,000 ($100,000 for a corporation) or imprisoned not more than one year (five years if IRC § 6050I applies), or both, plus the costs of prosecution.

Failure to Obey Summons IRC § 7210

Any person who is summoned to appear to testify or to appear and produce books and records or other papers as required under IRC §§ 7602, 7603, and 7604(b) and neglects to comply shall, upon conviction thereof, be fined:

- Not more than $1,000, or,
- Imprisoned not more than one year, or
- Both, plus costs of prosecution.

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Failure to Notify of Certain Foreign Transfers IRC § 6501(c)(8)

- IRC § 6501(c)(8) states - In the case of any information which is required to be reported to the Secretary under sections **6038**, **6038A**, **6038B**, **6046**, **6046A**, or **6048**, the time for assessment of any tax imposed by this title with respect to any event or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section.
- When a taxpayer fails to file complete and accurate information returns on **Forms 5471, 8865, 5472, 926, 3520 or 3520A**, the statute of limitations is held open for three years from the date the Service receives the complete and accurate information return.
- For example, a taxpayer timely files an incomplete or inaccurate Form 5471 and is notified by the Service that the form is inaccurate. The taxpayer then submits a corrected Form 5471 to the Service. The statute of limitations for any item on that Form 5471 is held open for three years from the date the Service receives the complete and accurate Form 5471.
- IRC § 6501(c)(8) does NOT hold open the statute of limitations on the entire income tax return, but only holds open any items of income or deductions in connection with the late filed information return.
- In the above example, the Service could make adjustments to any subpart F or related party transactions reported on the late filed 5471 for three years from the date received by the Service. However, the Service could not adjust an item of income or deduction not reported on the late filed Form 5471 (for example, depreciation on equipment).
- There is NO statute of limitation on any monetary penalty assessed under the above referenced code sections.

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Other Penalties, Continued

Reading Assignment

- IRC § 6683.
- IRC § 6689.
- IRC § 6038B.
- IRC § 6652.
- IRC § 6039E.
- IRC § 6039F.
- IRC § 6039G.
- IRC § 6046A.
- IRC § 6667.
- IRC § 6686.
- IRC § 6712.
- IRC § 6050I.
- IRC § 6712.
- IRC § 7343.
- IRC § 7203.
- IRC § 7210.
- IRM (20)900 - International Penalties.

Reasonable Cause

Purpose of Penalties

- It is important to assess penalties when appropriate. The purpose of penalties is to help enforce compliance with the tax laws. The penalties should be applied where appropriate.
- It is your responsibility to determine whether a taxpayer (or other person) has complied with the reporting/filing requirements, solicit any facts regarding reasonable cause, and make a determination of whether taxpayer has established reasonable cause.
- If reasonable cause does not exist, or exists for only a portion of the time, then you should compute the amount of the penalty to be asserted.
- If you need guidance, contact the International Technical Advisor for International Penalties.

Factors of Reasonable Cause

- Reference has been made several times to the phrase "reasonable cause" with respect to the nonapplicability of penalties.
- Determinations as to whether reasonable cause exists must be based on a careful consideration of the facts and circumstances of each case prior to the assertion of a penalty. You should consider any reason a taxpayer provides in conjunction with the guidelines, principles, and evaluating factors set forth in the Reasonable Cause chapter of IRM 20 (Penalty Handbook), as well as the applicable IRC section and regulations relating to the specific penalty.

Summary

Lesson Summary

- The IRC contains a large number of penalties, many of which are very complicated. This lesson provided only a brief overview of penalties which might be imposed. Seek guidance from the International Technical Advisor for clarification in unclear situations.
- The requirement to file Forms 5471 and 8865 is found in IRC §§ 6038, 6046 and 6046A. Penalties for failure to provide this information are authorized by IRC §§ 6038(b) and 6679 and their accompanying regulations.
- The requirement for Reporting Corporations to file Form 5472 and maintain certain records is found in IRC § 6038A. This section also contains the penalties for failure to comply with this section.
- The purpose of IRC § 6662(e)(1)(B) penalties is to encourage taxpayers to document their transfer pricing transactions and provide such documentation to the IRS.
- IRC § 6501(c)(8) holds open the statute of limitations when certain information returns are not filed or are incomplete or inaccurate when filed.
- Several other possible penalty assertions are possible. In all instances, consult the International Technical Advisor if you are unsure of when to assert a given penalty.

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Exhibit 1, *International Penalties in a Nutshell*

Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
874(a)	Failure of nonresident alien individual to file return	Denial of deductions and credits (other than credits under §§ 31-33 [tax withholding on wages], 34 [fuel excise taxes] and 852(b)(3)(D)(ii) [RIC shareholder basis adjustment for undistributed capital gains])	Yes	No, but protective return procedure under §1.874-1and if t/p acted in good faith	1040NR	Tax years after 2002
882(c) (2)	Failure of foreign corporation engaged in U.S. trade or business to file return	Denial of deductions (other than §170) and credits (other than credits under §§ 33 [tax withholding on wages], 34 [fuel excise taxes] and 852(b)(3)(D)(ii) [RIC shareholder basis adjustment for undistributed capital gains]). Does not apply for §541 purposes (PHC tax).	Yes	No, but protective return procedure under §1.882-4 and if t/p acted in good faith	1120-F	Tax years after 2002
999(f)	Willful failure to report international boycott	Fine up to $25,000, imprisonment up to 1 year, or both	n/a	n/a	n/a	1/1/78 -- Treasury makes annual report to

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
1445(d)(2)	Failure to furnish notice of false affidavit relating to withholding tax on dispositions of U.S. real property interest	Transferor's and transferee's agents are liable to deduct and withhold, limited to compensation amount for transaction	n/a	n/a	n/a	Dispositions after 1984
6038(b)	Failure to furnish information relating to CFCs and CFPs	$10,000 for initial failure and $10,000 continuation penalty for each 30-day period after 90 days notice (continuation penalty not to exceed $50,000) NOTE: CFP penalties for tax years beginning after 8/5/97, postponed until final regulations published on 7/22/98. NOTE ALSO, although a U.S. person who is the tax owner of an FDE is also required to file Form 8858, there is no penalty for	No	Yes	CFCs -- 5471, Sch. M CFPs – 8865 CFCs & CFPs w/FDEs 8858, Sch. M (not required in all cases)	CFCs -- tax years beginning after 1962; CFPs -- tax years ending on or after 12/31/00; CFCs & CFPs w/FDEs – tax years of tax owner (CFC or CFP) beginning on or after January 1, 2004.

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6038(c)	Failure to furnish information relating to CFCs and CFPs	10% reduction in foreign tax credit plus an additional 5% continuation penalty for each 3-month period after 90 days notice, total not to exceed the greater of $10,000 or foreign business income for accounting period of failure. NOTE: CFP penalties for tax years beginning after 8/5/97, postponed until final regulations published on 7/22/98. NOTE ALSO, although a U.S. person who is the tax owner of an FDE is also required to file Form 8858, there is no penalty for failure to file.	Yes	Yes	CFCs -- 5471, Sch. M CFPs -- 8865 CFCs & CFPs w/FDEs 8858, Sch. M (not required in all cases	CFCs -- tax years beginning after 1962; CFPs -- tax years ending after 12/31/00; CFCs & CFPs w/FDEs – tax years of tax owner (CFC or CFP) beginning on or after January 1, 2004

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Exhibit 1, *International Penalties in a Nutshell*, Continued

Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6038A (d)	Failure to furnish information or maintain records with respect to 25% foreign owned corporations	$10,000 for initial failure and $10,000 continuation penalty for each 30-day period after 90 days notice (reflects increase for failures after 11/5/90 for tax years beginning after 7/9/89)	No	Yes	5472	Tax years beginning after 1982
6038A (e)	Failure to (i) authorize the reporting corporation to act as agent of a foreign related party or (ii) substantially comply with a summons for informatio	Determination of deductions and costs for transaction based upon information available to Secretary	Yes	n/a	n/a	Tax years beginning after 7/10/89

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Exhibit 1, *International Penalties in a Nutshell*, Continued

Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6038B (c)	Failure to provide information relating to transfers to foreign persons (corporations and partnership)	10% of fair market value of property, not to exceed $100,000 (unless intentional disregard) and, if §721 contribution to foreign partnership, the gain is recognized (reflects change for post- 8/5/97 transfers/ exchanges)	No -- monetary Yes -- gain	Yes	926 8865 Sch O	Transfers or exchanges to corporations after 1984 and to partnerships after 8/5/97
6038C (c)	Failure to furnish information or maintain records with respect to foreign corporations engaged in U.S. business	$10,000 for initial failure and $10,000 continuation penalty for each 30-day period after 90 days notice	No	Yes	5472	Awaiting regulations (Enacted 11/5/90)
6038D (c)	Failure to file information with respect to foreign financial assets	$10,000 for initial failure and $10,000 continuation penalty for each 30-day period after 90 days notice (continuation penalty not to exceed	No	Yes	8938	Information due after 1/5/2010

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6039E (c)	Failure to provide statement concerning resident status	$500 for each failure of passport and green card applications submitted after 1/31/87 and 12/31/89, respectively, per Prop. Reg. §301.6039E-1	No	Yes	n/a	See Amount section
6039F (c)	Failure to file information relating to gifts from foreign individuals exceeding $100,000 (or from foreign corporations exceeding $10,000 adjusted for cost of living)	5% of the value of the gift for each month in which the gift is not reported (not to exceed 25%). Also, if the U.S. person fails to file, the tax consequences of the receipt of gift may be determined by the Secretary.	Yes -- §6039F(c)-(1)(A) tax consequence No -- §6039F(c)-(1)(B) Monetary Penalty	Yes	3520	Amounts received after 8-20-96
6039G (d)	Failure to provide tax return statement for year of termination by individual losing U.S. citizenship after	$10,000	No	Yes	8854	Information due after 6/7/97

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6652(f)	Failure to make a return with respect to foreign persons holding direct investments in U.S. real property interests	$25 per day (limited to the lesser of $25,000 or 5% of the fair market value of U.S. real property interests owned during the year)	Yes -- §6652(f)(1)	Yes	n/a	Awaiting §6039C regulations (Enacted as of 6/19/80)
6662(e)	Substantial valuation misstatement	20% of the underpayment of tax attributable to the “substantial valuation misstatement”	Yes	Yes, but restricted per §6662(e)(3)(D)	n/a	Returns due after 1990
6662(h)	Gross valuation misstatement	40% of the underpayment attributable to the “gross valuation misstatement”	Yes	Yes, but restricted per §6662(e)(3)(D)	n/a	Returns due after 1990
6677(a)	Failure to file information with respect to foreign trusts by U.S. owner and beneficiaries	35% of the gross reportable amount plus continuation penalty of $10,000 per 30-day period after 90 days notice (total not to exceed gross reportable amount) -- see	No	Yes	3520	Reportable events and distributions after 8/20/96 (see Notice 97-34 and Ann. 98-30 for transition rules)

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6677(b)	Failure to file notice of certain events relating to foreign trusts	5% of the gross reportable amount plus continuation penalty of $10,000 per 30-day period after 90 days notice (total not to exceed gross reportable amount) -- see Notice 97-34	No	Yes	3520-A	Tax years of U.S. person beginning after 1995 (see Ann. 98-30 for transition rules)
6679	Failure to file returns with respect to acquisitions of interests in foreign corporations or foreign partnerships under § 6046 or §6046A, or foreign personal holding company information under §6035	For foreign corporations and foreign partnerships, $10,000 plus continuation penalty of $10,000 for each 30-day period after 90 days notice (continuation penalty not to exceed $50,000) (reflects increase for transfers/changes after 8/5/97); For foreign personal holding companies (FPHCs), $10,000 penalty per return for tax years of foreign	No -- §6679(b)	Yes	5471, Sch. O for §6046. 8865 Sch. P for §6046A 5471 Sch. N for §6035	Corporations -- 1/1/63 Partnerships -- 1/1/00 FPHC 1/1/63-12/31/04 NOTE: FPHC provisions repealed effective taxable yrs. Of foreign corp. beginning after 12/31/04, and to tax years of U.S. s/hs w/ or w/in which such tax year of foreign corp ends.

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
		beginning before 1/1/05 (see note under effective date).				
6686	Failure to file returns or supply information by DISC or FSC	$1,000 for each failure to supply information not to exceed $25,000; $1,000 for each failure to file return	Yes	Yes	1120-DISC, 1120-IC-DISC, or 1120-FSC	DISC -- tax years beginning after 1971; FSC -- tax years ending after 1984
6688	U.S. possession information of bona fide individual residents	$100 for each failure to file Form 5074 with U.S. income tax return. **Effective for tax years ending after 10-22-2004** - penalty is increased to $1,000 per failure	Yes	Yes	5074	Tax years beginning after 1972
6689	Failure to file notice of foreign tax redetermination under §905(c) or §404A(g)(2)	5% of the deficiency if the failure is for not more than one month, and an additional 5% for each month or fraction thereof while the failure continues (total not to exceed 25% of the	Yes	Yes	1116 or 1118 (attach to 1040X or 1120X)	Awaiting notice (applies to redeterminations after 1979)

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Penalty Section	Description	Amount	Deficiency Procedures	Reasonable Cause Relief	Form	Effective Date
6689	Failure to file notice of foreign deferred compensation plan under §404A(g)(2)	5% of the deficiency if the failure is for not more than one month, and an additional 5% for each month or fraction thereof while the failure continues (total not to exceed 25% of the deficiency)	Yes	Yes	n/a	Awaiting regulations (applies to employer contributions for tax years after 1979)
6712	Failure to disclose treaty-based return position	For each separate treaty-based position taken and not properly disclosed, $10,000 for C corporations and $1,000 for all other taxpayers	Yes	Yes	8833 or statement	Returns due after 1988
7270	Failure to comply with requirements of §4374, relating to liability for tax on policies issued by foreign	Fine of double the amount of tax	n/a	n/a	n/a	Effective 2/1/77

Exhibit 2, Information Return noncompliance penalties

INFORMATION RETURN FILING REQUIREMENTS
(AND PENALTIES FOR FAILURE TO FILE)

Form 3520 – (IRC §§ 6039F and 6048 - Effective for returns due after August 20, 1996)

There are several situations in which a Form 3520 (or statement with similar information) is required to be filed. The most common are where a U.S. person:

1. Creates or transfers money or property to a foreign trust (IRC § 6048(a))
2. Receives (directly or indirectly) any distributions from a foreign trust (IRC § 6048(c))
3. Receives certain gifts or bequests from foreign entities (IRC § 6039F)

Form 3520 is due (filed with the Philadelphia Service Center) on the date that the U.S. person's individual income tax return is due, including extensions. Form 3520 (MFT 68) is on the Master File for 1998 and subsequent years. For prior years, determining if a Form 3520 has been filed requires special assistance from the Philadelphia Campus. Refer to the following chart for a more detailed listing of the responsibilities for filing.

Form 3520 CHART - Events Requiring Filing of Form 3520

Reportable Events	Required Filer
Creation of, or direct or indirect **transfer** of money or property to, a foreign trust. Exceptions: • Transfers to employee benefits trusts (described in IRC §§ 402(b), 404(a)(4) or 404A). • FMV transfers to nongrantor trusts with no "qualified obligation" involved. • Transfers to foreign trusts with a current IRC § 501(c)(3) determination letter. • Transfers to a qualified Canadian Registered Retirement Savings Plan	**U.S. creator or transferor**

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Reportable Events	Required Filer
Death of a U.S. person who was either: • Treated as the owner of a portion of a foreign trust under the grantor trust rules (IRC §§ 671-679), or • Whose estate included any portion of a foreign trust.	**Executor of the estate**
A trust, which was not a foreign trust, **became** a foreign trust during the taxable year.	**Foreign Trust**
Treatment as an owner of any portion of a foreign trust under the grantor trust rules (IRC §§ 671-679). Exception: • Ownership of a qualified Canadian Registered Retirement Savings Plan.	**U.S. person treated as owner**
Having an outstanding **obligation** to a foreign trust as a "qualified obligation." By definition, a qualified obligation 1) must be reduced to writing; 2) have a term not to exceed five years; 3) all payments must be denominated in U.S. dollars, 4) interest rate must be tied to the Federal rate; 5) U.S. persons agree to extend the statute of limitations on their tax return to three years beyond maturity date; AND 6) U.S. person reports status of the note (principal/interest).	**U.S. obligor**
Receipt of any distribution (including **Gifts**) from a foreign trust. Exceptions: • Distributions for a qualified Canadian Registered Retirement Savings Plan. • Distributions taxable as compensation for services rendered, if reported on recipient's tax return. • Distributions to a U.S. trust with a current IRC § 501(c)(3) determination letter.	**U.S. recipient (from a foreign trust)**

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Exhibit 2, *Information Return noncompliance penalties*,
Continued

Reportable Events	Required Filer
• More than $100,000 from a nonresident alien individual or foreign estate (or from a foreign person related to such individual or estate) treated as **Gifts or bequests**, or • More than $10,000* from foreign corporations or foreign partnerships (or from a foreign person related to such corporation or partnership) treated as **Gifts** (* Note: The amount increases after 1996 for cost-of-living adjustments - IRC § 6039A).	**U.S. recipient (other)**

Statute Dates

The statute date associated with Form 3520 is the same as the income tax return to which the Form 3520 applies.

Penalties for Failure to File Form 3520 (or filing an incomplete or incorrect Form 3520)

IRC § 6677 states:

"In addition to any criminal penalty provided by law, if any notice or return required by section 6048 –

1. Is not filed on or before the time provided in such section, or
2. Does not include all the information required pursuant to such section or includes incorrect information,

The person required to file such notice or return shall pay a penalty equal to 35 percent of the gross reportable amount."

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Exhibit 2, *Information Return noncompliance penalties*,
Continued

If a Form 3520 was required to be filed as the result of a "gift" (under IRC § 6039F), then IRC § 6059F(c) imposes a penalty equal to 5% per month of the "gift," not to exceed a total of 25% in the aggregate. There is no provision in IRC § 6039F for additional penalties if the failure to file continues beyond five months. The "gross reportable amount" is dependent on the type of failure involved.

Type of Failure	Gross Reportable Amount (Penalty Base)
Failure to report creation of a foreign trust (IRC § 6048(a)(3)(A)(i))	Gross value of property involved in the reportable event as of the date of the event
Failure to report transfer to a foreign trust (IRC § 6048(a)(3)(A)(ii))	Gross value of property involved in the reportable event as of the date of the event
Failure to report death of a U.S. person if treated as the owner of a foreign trust (IRC § 6048(a)(3)(A)(iii)	Gross value of property involved in the reportable event as of the date of the event
Failure to report distribution from a foreign trust (IRC § 6048(c))	Gross amount of distributions
Failure to report receipt of foreign gifts (IRC§ 6039F)	Amount of such foreign gifts

Upon making a determination that a Form 3520 was required to be filed, notice of such determination should be mailed to the person required to file the return. Contact your local Counsel for the suggested language of such notice. If the failure to file continues (after 90 days from the mailing of the notice), there is an additional penalty of $10,000 for each 30-day period (or fraction thereof) during which such failure continues. In no event shall the penalty under this subsection with respect to any failure exceed the gross reportable amount. Refer to IRC § 6677(d) for the "reasonable cause exception."

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Form 3520-A – (IRC § 6048(b))

Any U.S. person who is considered to be the "U.S. owner" of a foreign trust must file Form 3520-A. This form is due on the 15th date of the 3rd month after the end of the trust's tax year (March 15 for a calendar year return). Form 3520-A must be filed with the Philadelphia Campus (formerly known as "Service Center"). The determination of whether or not a U.S. person is a "U.S. Owner" is made using the provisions of IRC §§ 671-679 (Grantors and Others Treated as Substantial Owners), but primarily the following sections:

IRC § 673 Reversionary Interests
IRC § 674 Power to control beneficial enjoyment
IRC § 675 Administrative powers
IRC § 676 Power to revoke
IRC § 677 Income for benefit of grantor
IRC § 678 Person other than grantor treated as substantial owner
IRC § 679 Foreign trusts having one or more United States beneficiaries

Form 3520-A (MFT 42) is on the Master File for 2000 and subsequent years. For prior years, determining if a Form 3520-A has been filed requires special assistance from the Philadelphia Campus.

Statute Dates

The statute date associated with Form 3520-A is the 15th day of the third month after the end of the trust's tax year (generally, March 15). An extension of time to file may be requested using Form 2758.

Penalties for Failure to File Form 3520-A (or filing incomplete/incorrect Form 3520-A)

IRC § 6677(b) imposes a penalty for failure to file a Form 3520-A (or filing an incomplete or incorrect Form 3520-A) equal to 5% of the gross reportable amount. The "gross reportable amount" is defined in IRC § 6677(c)(2) as "the gross value of the portion of the trust's assets at the close of the year treated as owned by the United States person"

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Form 3520-A – (IRC § 6048(b)) (continued)

Upon making a determination that a Form 3520-A was required to be filed, notice of such determination should be mailed to the person required to file the return. Contact your local Counsel for the suggested language of such notice. If the failure to file continues (after 90 days from the mailing of the notice), there is an additional penalty of $10,000 for each 30-day period (or fraction thereof) during which such failure continues. In no event shall the penalty under this subsection with respect to any failure exceed the gross reportable amount. Refer to IRC § 6677(d) for the "reasonable cause exception."

Form 5471 – (IRC § 6038)

Form 5471 is required in situations where a U.S. shareholder is determined to be the owner of a "controlled foreign corporation." A controlled foreign corporation ("CFC") is a foreign corporation, the stock of which is more than 50 percent owned (by vote, or value, at any time during the year) by "U.S. Shareholders." A "U.S. Shareholder" is defined in this context as a U.S. person who owns a total, (directly, indirectly, or constructively) of at least 10% of the stock by vote or value. Refer to IRC § 957 for additional information about CFCs and IRC § 958 for stock ownership rules. The importance of this information is that U.S. shareholders of CFCs are deemed to receive their pro rata shares of certain types of income earned by the CFC ("Subpart F income"), whether distributed as dividends or not.

Form 5471 is due on the date that the U.S. person's income tax return is due (individual or corporate), including extensions. The Form 5471 must be attached to the U.S. person's income tax return and a copy must be filed with the Philadelphia Campus (formerly known as "Service Center"). For a more detailed listing of the responsibilities for filing, refer to the Form 5471 Instructions. Form 5471 is NOT maintained on the Master File. If Form 5471 is not attached to the tax return, determining if it was filed requires special assistance from the Philadelphia Campus.

Statute Dates

The statute date associated with Form 5471 is the same as the income tax return to which the Form 5471 applies.

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Form 5471 – (IRC § 6038) (continued)

Penalties for Failure to File Form 5471 (or filing an incomplete or incorrect Form 5471)
IRC § 6038(b) states, "If any person fails to furnish, within the time prescribed under paragraph (2) or subsection (a), any information with respect to any foreign business entity required under paragraph (1) of subsection (a), such person shall pay a penalty of $10,000 for each annual accounting period with respect to which such failure exists."

Upon making a determination that a Form 5471 was required to be filed, notice of such determination should be mailed to the person required to file the return. Contact your local Counsel for the suggested language of such notice. If the failure to file continues (after 90 days from the mailing of the notice), there is an additional penalty of $10,000 for each 30-day period (or fraction thereof) during which such failure continues. In no event shall the penalty under this subsection with respect to any failure exceed $50,000. Refer to the IRC § 6038 Regulations for reasonable cause exceptions.

Form 5472 – (IRC § 6038A and 6038C)

Form 5472 is required to be filed by a "reporting corporation" that has "reportable transactions" with foreign or domestic related parties. A "reporting corporation" is one that is either a 25% foreign-owned corporation or a foreign corporation engaged in a trade or business within the United States. A corporation is 25% foreign-owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year. "Reportable transactions" consist of a number of different types of transactions as listed on the Form 5472 instructions.

Form 5472 is due on the date that the corporation's income tax return is due, including extensions. The Form 5472 must be attached to the corporation's income tax return and a copy must be filed with the Philadelphia Campus (formerly known as "Service Center"). If the corporation's income tax return is not filed when due, the Form 5472 should be timely-filed with Philadelphia and a copy can then be attached to the corporate return when filed. Form 5472 is **NOT** maintained on the Master File. If Form 5472 is not attached to the tax return, determining if it was filed requires special assistance from the Philadelphia Campus.

Statute Dates

The statute date associated with Form 5472 is the same as the income tax return to which the Form 5472 applies.

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Form 5472 – (IRC § 6038A and 6038C) (continued)

Penalties for Failure to File Form 5472 (or filing an incomplete or incorrect Form 5472)
IRC § 6038A(d) states, "If a reporting corporation fails to furnish (within the time prescribed by regulations) any information described in subsection (b), or fails to maintain (or otherwise cause another to maintain) records as required by subsection (a), such corporation shall pay a penalty of $10,000 for each taxable year with respect to which such failure occurs"

Upon making a determination that a Form 5472 was required to be filed, notice of such determination should be mailed to the person required to file the return. Contact your local Counsel for the suggested language of such notice. If the failure to file continues (after 90 days from the mailing of the notice), there is an additional penalty of $10,000 for each 30-day period (or fraction thereof) during which such failure continues. Currently, there is no limit to how long the penalty can continue. Refer to the IRC § 6038A Regulations for reasonable cause exceptions. There is a "Small Corporation" exception to the record maintenance requirements of Treas. Reg. § 1.6038A-3 and the authorization of agent provisions of Treas.Reg. § 1.6038A-5. Corporations with less than $10,000,000 in U.S. gross receipts are not subject to those two regulations, but must still file the required Form 5472.

Form 8865 – (IRC §§ 6038, 6038B, and 6046A)

Form 8865 is used to report the information required under IRC § 6038 (with respect to controlled foreign partnerships), IRC § 6038B (transfers to foreign partnerships), or IRC § 6046A (acquisitions, dispositions, and changes in foreign partnership interests). For more information about the requirements to file, refer to the Form 8865 Instructions. Within the instructions, there are four categories of filers. If a U.S. person falls into one of the four categories, they must file Form 8865 by attaching it to their income tax return and filing it by the due date (including extensions). If an income tax return is not due, the Form 8865 must be filed at the time and place the U.S. person would have filed an income tax return, if it had been required.

Continued on next page

Statute Dates

The statute date associated with Form 8865 is the same as the income tax return to which the Form 8865 is attached. **IT IS IMPORTANT TO NOTE**, however, that the failure to file a Form 8865 has a significant impact on the statute of limitations with respect to the information for which the 8865 is required. Refer to the discussion at IRC § 6501(c)(8).

Penalties for Failure to File Form 8865 (or filing an incomplete or incorrect Form 8865)

The penalties for failure to file are dependent upon the category of filer involved (as explained in the Form 8865 Instructions). Refer to the following chart in making a penalty determination.

Category of Filer	Code Section	Penalty for Failure to File (or properly report required information)
1 or 2	6038	$10,000 for each tax year of each foreign partnership. If the required information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign partnership) is charged for each 30-day period (or fraction thereof) during which the failure continues after the 90-day period has expired. The maximum amount of the additional penalty is $50,000.
3	6038B	10% of the fair market value of the property contributed. This penalty is subject to a $100,000 limit, unless the failure is due to intentional disregard. In addition, the transferor must recognize gain on the contribution as if the contributed property had been sold for fair market value.
4	6046A	$10,000 with same additional $10,000 penalty and $50,000 maximum as described above for Category 1 and 2 filers.

Upon making a determination that a Form 8865 was required to be filed (under IRC §§ 6038 or 6046A), notice of such determination should be mailed to the person required to file the return. Contact your local Counsel for the suggested language of such notice.

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Form 926 – (IRC § 6038B)

Form 926 is required to be filed by each U.S. person who transfers property to a foreign corporation in an exchange described in IRC §§ 332, 351, 354, 355, 356, or 361. The form is also required if the U.S. person makes a distribution described in IRC § 336 to a non-U.S. person. For special rules regarding the filing of Form 926, refer to the instructions on the form. The form is required to be filed as an attachment to the U.S. transferor's annual tax return for the tax year that includes the date of the transfer.

The Code sections listed above for the Form 926 include the following situations:

- IRC § 332 - Complete liquidation of subsidiaries
- IRC § 336 - Gain or loss recognized on property distributed in complete liquidation
- IRC § 351 - Transfer to corporation controlled by transferor
- IRC § 354 - Exchanges of stock and securities in certain reorganizations
- IRC § 355 - Distribution of stock and securities of a controlled corporation
- IRC § 356 - Receipt of additional consideration
- IRC § 361 - Nonrecognition of gain or loss to corporations; treatment of distributions

To determine if a Form 926 has been filed, use MFT 81 to research the Master File.

Statute Dates

The statute date associated with Form 926 is the same as the income tax return to which the Form 926 is attached. **IT IS IMPORTANT TO NOTE**, however, that the failure to file a Form 926 has a significant impact on the statute of limitations with respect to the information for which the 926 is required. Refer to the discussion at IRC § 6501(c)(8).

Penalties for Failure to File Form 926 (or filing an incomplete or incorrect Form 926)

IRC § 6038B(c) states, "If any United States person fails to furnish the information described in subsection (a) at the time and in the manner required by regulations, such person shall pay a penalty equal to 10 percent of the fair market value of the property at the time of the exchange…" The penalty with respect to any exchange shall not exceed $100,000 unless the failure with respect to such exchange was due to intentional disregard.

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Exhibit 2, *Information Return noncompliance penalties*,
Continued

TD F 90.22-1 (Title 31, United States Code, § 103)

Form TD F 90.22-1 is a U.S. Treasury form required of each United States person, who has a financial interest in or signature authority, or other authority over any financial accounts, including bank, securities, or other types of financial accounts in a foreign country, if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year. Refer to page 3 of the document for instructions into who must file and exceptions. In *Clines*, 958 F.2d 578 (4th Cir. 1992), the Court interpreted the terms "financial institution" and "control or other authority" very broadly, holding that the reporting requirement extended to a capital account maintained on the ledger of a Swiss corporation that made distributions from time to time as instructed by the taxpayer.

Form TD F 90.22-1 must be filed with the Department of the Treasury on or before June 30 of the year following the year in which the reportable event occurred.

Statute Dates

Unlike the other forms discussed in this section, the TD F 90.22-1 does NOT affect the statute of limitations for the purpose of assessing federal income taxes. There are no provisions for the extension of the statute of limitations for the taxpayer's failure to file Form TD F 90.22-1.

Penalties for Failure to File Form TD F 90.22-1

Currently, the authority to assess penalties for a taxpayer's failure to file Form TD F 90.22-1 lies with the Department of the Treasury (not the IRC). As of the printing of this document, that authority has not shifted. **The revenue agent who discovers a potential Title 31 violation should refer any evidence of that violation to the Area Anti-Money Laundering Coordinator (generally, assigned to the Planning and Special Programs staff).**

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Exhibit 3, *International Penalties per IRM 20*

International Penalties Per IRM 20

<u>IRM Section 20.1.9, International Penalties</u>

IRM SubSection 20.1.9.1 – Overview

This section of the consolidated penalty IRM discusses penalties assessed against taxpayers that are U.S. persons doing business outside the United States, and foreign entities doing business in the United States. **Unless otherwise indicated, the term "U.S. person" includes individuals, corporations, partnerships, estates or trusts. Refer to IRC § 7701(a).**

IRM Sub-SubSection § 20.1.9.1.1 – Chapter Outline

The penalties listed below are discussed in detail in this section. As of the date of publication of this IRM, regulations have not been issued regarding the penalty or the application of the penalty so noted [*]. Therefore, the penalty should not be imposed until regulations are published.
Caution: It is important that, before assertion of any penalty, the examiner be aware of the statute, regulations, any exceptions or limitations, etc. that may apply to the case at hand. This chapter only provides a brief description of each penalty and is not meant to be a substitute for research.

IRC Section	Description
6038(b)	Failure to furnish information with respect to controlled foreign corporation. IRC § 6038(a).
6038(c)	Failure to furnish information with respect to controlled foreign corporation. IRC § 6038(a).
6038A(d)	Failure to furnish information or to maintain records by certain 25 percent foreign owned corporations. IRC § 6038A(a).
6038A(e)	Failure to authorize an agent or failure of a reporting corporation to substantially and timely comply with a summons for records. IRC § 6038A(e).
6038B(b)	Failure to furnish information on transfers of property to foreign persons. IRC § 6038B(a).
6038C(c)*	Failure to furnish information or maintain records by a foreign corporation engaged in U.S. trade or business. IRC § 6038C(a). Regulations have not been issued.
6038C(d)*	Failure to authorize an agent or failure of a reporting corporation to substantially and timely comply with a summons for records. IRC § 6038A(e). Regulations have not been issued.

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6652(f)*	Failure to provide information on foreign persons holding direct investment in U.S. real property. IRC § 6039C. Regulations have not been issued.
6677	Failure to file information returns with respect to certain foreign trusts. IRC § 6048.
6679*	Failure to file required information with respect to certain foreign corporations or foreign partnerships. IRC §§ 6035, 6046 and 6046A. Regulations have not been issued under IRC § 6046A.
6686	Failure by DISC or FSC to file return or supply information. IRC § 6011(c).
6688	Failure to meet requirements of coordination of U.S. and possession individual income tax as specified. IRC § 7654.
6689	Failure to file notice of redetermination of foreign tax. IRC §§ 905(c) and 404A(g).
6712	Failure to disclose treaty-based return positions. IRC § 6114.

A quick reference chart of reporting/filing responsibilities of taxpayers, and applicable penalties is in **Exhibit 20.1.9-1** of this section.

The guidelines and administrative procedures for the penalties are discussed in IRM Section 20.9.2, Penalty Guidelines and Procedures.

20.1.9.1.2 (04-22-2011)
Other Penalties

(1). Criminal penalties should be considered for U.S. and foreign taxpayers who willfully fail to file a return (IRC 7203) or file a false or fraudulent return (IRC 7206 and IRC 7207).

(2). IRC 6662(e), *Substantial Valuation Misstatement*, and IRC 6662(h), *Increase in Penalty in Case of Gross Valuation Misstatements*, address the coordination of IRC 482 transfer price adjustments.

(3). The following reporting/filing requirements are subject to failure to deposit penalties as discussed in IRM 20.1.4, *Failure to Deposit Penalty*:

Continued on next page

IRC section	Subject	Applicable Form
IRC 1441	Withholding of Tax on Nonresident Aliens	Form 1042 Form 1042-S
IRC 1442	Withholding of Tax on Foreign Corporations	
IRC 1446	Withholding Tax on Foreign Partners' Share of Effectively Connected Income	

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20.1.9.1.3 (04-22-2011)
31 U.S.C. 5321 -- TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR)

(1). Generally, a U.S. person having one or more foreign accounts with maximum balances totaling over $10,000 for any calendar year is required to maintain records and file Form TD F 90-22.1 with the Internal Revenue Service by June 30th of the following year.

(2). A penalty applies—

a) Under 31 U.S.C. 5321(a)(5)(B) for any non-willful violation of the recordkeeping and filing requirements under 31 U.S.C. 5314,

b) Under 31 U.S.C. 5321(a)(5)(C) for any willful violations of the recordkeeping and filing requirements under 31 U.S.C. 5314,

c) Under 31 U.S.C. 5314, 5321(a)(6)(A) for negligently failing to meet the filing and recordkeeping requirements for financial institutions or non-financial trades or businesses under 31 U.S.C. 5314 and 31 C.F.R. 103.24, or 31 C.F.R. 103.32, and

d) Under 5321(a)(6)(B) for a pattern of negligent violations of any provision of 31 U.S.C. 5311-5332.

(3). See IRM 4.26.16, *Report of Foreign Bank and Financial Accounts (FBAR)*, for FBAR penalty computation rules and mitigation guidelines. See IRM 4.26.17 *Report of Foreign Bank and Financial Accounts (FBAR) Procedures*, for FBAR penalty procedures.

(4). See 31 U.S.C. 5321(b) for the statute of limitations on assessment and collection.

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20.1.9.1.4 (04-22-2011)
Voluntary Disclosure Special Process

(1). Criminal Investigation's (CI's) Voluntary Disclosure Practice is described in IRM 9.5.11.9, *Voluntary Disclosure Practice.*

(2). The 2009 Offshore Voluntary Disclosure Program (2009 OVDP) was available to taxpayers beginning March 23, 2009, for voluntary disclosures received by the IRS through October 15, 2009. The penalty was asserted on Form 8278 in the following manner:

   a) The penalty was a percentage of the amount in foreign bank accounts, or fair market value of assets, that was paid in lieu of other penalties during the **six year look-back period.**
   b) **PRN 595** was designated for a **5 percent** reduced penalty in certain circumstances, and
   c) **PRN 596** was designated for a **20 percent** penalty.

(3). The 2011 Offshore Voluntary Compliance Initiative (2011 OVDI), with a different penalty framework, was available to taxpayers beginning February 8, 2011, for voluntary disclosures received by the IRS through August 31, 2011. The penalty is asserted on Form 8278 in the following manner:

   a) The penalty was a percentage of the amount in foreign bank accounts, or fair market value of assets, that was paid in lieu of other penalties during the **eight year look-back period.**
   b) **PRN 595** was designated for a **5 percent** reduced penalty for certain taxpayers with little connection to their accounts or who did not know they were U.S. citizens,
   c) **PRN 597** was designated for a **12.5 percent** penalty for smaller offshore accounts or assets that did not surpass $75,000 in any calendar year, and
   d) **PRN 598** was designated for a **25 percent** penalty.

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20.1.9.2 (04-22-2011)
Assessment Procedures for Penalties Not Subject to Deficiency Procedures

(1). This section provides general procedures common to the international penalties. Exceptions are noted in the discussion of the specific penalties.

(2). Generally, the penalties included in this section are asserted by international examiners, revenue agents, tax auditors, tax compliance officers, tax examiners, or estate and gift tax attorneys (collectively referred to hereafter as "examiner(s)") after inquiring about the event, information return or requesting the return from the taxpayer.

Note: In certain situations, the examiner will make the determination that the return is required without first contacting the taxpayer with respect to an income tax examination.

(3). Examiners must perform appropriate research when addressing these penalties. Technical advisors can provide additional information on specific provisions. See Exhibit 20.1.9-1, *Quick Reference Guide to International Penalties*. For other detailed examination procedures on international penalties, refer to IRM 4.60.8, *International Examination and Processing Procedures.*

(4). Deficiency procedures under Subchapter B of Chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) do not apply to penalties discussed in this section. See Exhibit 20.1.9-4, *International Penalties Subject to or Not Subject to Deficiency Procedures.*

(5). U.S. and foreign taxpayers are subject to criminal penalties such as willful failure to file a return (IRC 7203) and filing a false or fraudulent return (IRC 7206 or IRC 7207). If at any point these IRC sections apply, examiners must discuss the situation with their manager and the fraud technical advisor before further contacting the taxpayer.

(6). Penalties are assessed on U.S. persons as defined in IRM 20.1.9.1.1(1).

(7). **Requirement to File** - The examiner must determine that the information return was required to be filed before referring to the information listed under the individual IRC section and Penalty Reference Number (PRN). The following types of information support a presumptive requirement to file an international information return:

Continued on next page

a) Testimony of the taxpayer or other reliable persons.
b) Late filed return.
c) A filed return indicating that information returns are due for prior or subsequent periods or for related entities.
d) A filed return that does not include all the required information or the required supporting information was not provided when requested.
e) Information that the taxpayer has control over, is receiving benefits from, is receiving distributions or income from an account in the name of a foreign entity.
f) Statement in the name of the foreign entity addressed to the taxpayer.
g) Information received from promoter investigations that indicates the taxpayer owns or has control over a foreign entity, is controlled by a foreign entity, or meets another filing requirement.

(8). **Fact of Filing** - The examiner must determine that the information return (with complete and accurate information) has not been filed or was filed after the required date. Also note that:

a) Generally, the information returns or statements are required to be attached to the related income tax return and the due date is the same as the related income tax return (including extensions). Specific exceptions are noted for each penalty separately.
b) Some returns have dual filing requirements and the penalty can apply for failure to file either return.
c) Examiners should focus on the requirement to attach the information return to the related income tax return when determining whether or not the required return has been filed timely.

(9). **Referral** - Domestic examiners must make a referral on the Specialist Referral System for international assistance when they are assigned a case which involves international information returns. The specialist electronic referral home page is: http://srs.web.irs.gov/Default.asp.

Note: SB/SE examiners have been delegated the authority to issue penalty letters when referrals are not accepted, and to make all other penalty determinations. See IRM 1.2.43, *Delegations of Authority for the Examining Process*. When the examiner secures a required return that was not originally filed, the examiner should attach the return and enter appropriate comments in the workpapers.

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(10). **Penalty Case Control** - When an examiner determines that an information return is due, has not been filed, or has been filed but is not complete or accurate, and that a penalty applies, the examiner should request approval for a penalty investigation from their manager, establish penalty case controls and prepare a penalty case file. The file must include the information that supports the requirement to file and establishes that the information return has not been filed.

(11). **Request the Returns** - Examiners should inform the taxpayer of the requirements to file the information returns and of the intent to assess the penalty for failure to comply. The Initial Penalty can be assessed without advanced notification. However, examiners should inform the taxpayer prior to assessing the penalty. Examiners must take steps to secure appropriate documentation to support the requirement to file the returns. This information may also be necessary for the related income tax examination.

(12). **Notice Letter Provisions** - Penalties under IRC 6038, IRC 6038A, IRC 6038D, IRC 6677, and IRC 6679 have "Notice Letter" provisions, and a Continuation Penalty may apply. The provisions state that:

a) If the required returns are not filed on or before the 90th day after the Notice Letter is issued, additional penalties of $10,000 per month (or fraction thereof) may be assessed.

b) The penalty continues to be increased until the required information is received, or the information returns are filed, or the maximum penalty is assessed.

c) The maximum penalty amount for the Continuation Penalty is different for each IRC section and is referenced in each penalty section.

(13). **Notice Letters** - Examiners must issue Notice Letters at the earliest date possible. The taxpayer must respond within a specified period after the date the letter was issued. Notice Letters also provide an opportunity for the taxpayer to produce information to prove that the information return in question was not required to be filed, or to request reasonable cause for the failure to timely file. Notice Letters are available through http://publish.no.irs.gov/catlg.html. Required language for additional letters is available from the international penalty technical advisor, IRC, notices, and regulations.

a) Notice Letters are addressed to the U.S. person responsible for ensuring that the required returns are filed and include the name of the related foreign entity.

b) Notice Letters must be signed by an examination group manager in SB/SE or a revenue agent in LB&I.

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c) Notice Letters instruct the taxpayer to mail the information returns to the address of the examiner issuing the letter. However, Notice Letters can be issued directly to the taxpayer. The examiner should get a receipt from the taxpayer on the date of delivery. Many Notice Letters have a specified response period prior to a Continuation Penalty being asserted. The receipt is proof of the date the Notice Letter was issued.

d) There is no provision in the IRC or Treasury Regulations for an extension of the 90-day period described in the Notice Letter. However, the running of the 90-day period may be suspended by other IRC sections not specific to these penalties.

(14). **Secured Returns** - When an examiner secures a delinquent information return and/or statement, determine if it provides all of the required information and is accurate. If the return is incomplete or inaccurate, the examiner must inform the taxpayer that the return is not considered filed until it is complete and accurate. For complete and accurate returns, perform the following actions:

Note: For purposes of this paragraph, a "delinquent information return" does not include Form 3520 (See IRM 20.1.9.10 and IRM 20.1.9.13) which is separately processed to Business Master File (BMF) under MFT 68, or Form 3520-A (See IRM 20.1.9.14) which is separately processed to BMF under MFT 42.

STEP	Action
1.	Date stamp and make 1 photocopy of the document.
2.	Associate the original document with the related income tax return. Often, the received date of the information return affects the statute for assessment on the related income tax return. See IRC 6501(c) (8).
3.	Place the photocopy in the penalty case file. The return received will be kept in the penalty case file and the related income tax file.

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(15). **Reasonable Cause** - Examiners must consider any reason a taxpayer provides in conjunction with the guidelines, principles and evaluating factors relating to reasonable cause based on the facts and circumstances. Examiners should be mindful of the fact that, generally, these penalties apply to individuals who have business or investment activities in foreign countries, and, as such, general care and prudence requires researching the filing and tax obligations of all jurisdictions. See Exhibit 20.1.9-5, *Reasonable Cause Relief*, the IRC, and the Treasury Regulations relating to the specific penalty. Also examiners should note the following:

a) Reasonable cause should not be considered until the taxpayer is in compliance with respective provisions of the law.
b) Reasonable cause does not apply to the Initial Penalty in some IRC sections.
c) Many of the penalty sections have specific provisions for reasonable cause.
d) Examiners must issue a determination letter if the taxpayer requests reasonable cause consideration and it has been denied.
e) Reasonable cause determinations can only be made by the unit that asserted the penalty (e.g., Campus cannot allow reasonable cause for a penalty asserted by LB&I, TE/GE, or SB/SE Field Office Examination).

(16). **Compute the Penalties** - After the examiner has determined that a penalty applies, the examiner must compute the amount of the penalty and prepare the assessment documents. Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*, and Form 886-A, *Explanation of Items*, are required. The penalty amounts are discussed in the section for each penalty. Penalty computation time frames are as follows:

a) Penalties will be computed until the date returns are filed, or until the required information is received, or until the maximum penalty amount is reached.
b) For penalties without Notice Letter provisions, or if no Notice Letter was issued: (i) Assess penalties promptly after receipt of the required returns or return information, or (ii) If no return is received, assess penalties 90 days after the request for the return.

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(17). **Penalties with a Notice Letter Provision** - When the examiner does not receive a response from the taxpayer, it is recommended that the initial assessment package be prepared on or after the 125th day, but before the 150th day, after the date that the Notice Letter was issued. As a result, the first penalty assessment would be for the Initial Penalty plus two months of the Continuation Penalty.

Example: For one delinquent Form 5471 the first assessment of the penalty would be $30,000:

Description	Penalty Reference Number	Penalty Amount
Initial Penalty	623	$10,000
Continuation Penalty	619	$20,000

(18). The examiner must maintain a copy of the Initial Penalty case file for subsequent assessments if noncompliance continues. Please note:

a) The second and subsequent (if applicable) assessments of the Continuation Penalty should be made after 215 days from the date of the Notice Letter, unless the maximum penalty amount has been reached.

b) As a result, any subsequent assessment(s) will be for three months: $30,000 for each required return.

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Example: For one Form 5471:

	Description	Penalty Reference Number	Penalty Amount
1.	Initial Penalty	623	$0.
2.	Continuation Penalty	619	$30,000. This would be the maximum penalty for IRC 6038 for one un-filed Form 5471
3.	The process in "2" should be continued every 3 months until the maximum penalty is reached or until an administrative decision is made to suspend additional assessments.		

(19). **Continuation Penalties** - A Continuation Penalty is associated with several penalties and can either be assessed at the same time as the Initial Penalty, or at a later date. There are maximum limits to some Continuation Penalties while others have no limitation on the amount that can be assessed. Additional information about each Continuation Penalty is presented in the respective penalty sections that follow. In addition:

a) **Penalty Case Control** - Once the Initial Penalty case file (either the Initial Penalty alone or the Initial Penalty along with the first Continuation Penalty) is closed, subsequent Continuation Penalties are not automatically assessed. Separate penalty case files will need to be developed for each subsequent Continuation Penalty. It is recommended that every three months in which the taxpayer noncompliance continues, the examiner request approval from their manager to open a new Continuation Penalty case file until the maximum penalty is reached or until an "administrative decision" is made to suspend additional adjustments.

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b) **Administrative Decision** - For those Continuation Penalties that do not have a maximum limit, managers must weigh the facts and circumstances of the taxpayer in determining how long to pursue Continuation Penalties for each taxpayer.

(20). **Approval** - IRC 6751 requires that managers approve penalties prior to assertion. Managers must approve the case control, sign the Notice Letters, and approve the case prior to closing.

Note: Notice Letters issued by SB/SE must be signed by the group manager. Notice Letters issued by LB&I can be signed by the LB&I revenue agent.

(21). **Payment** - To process payments use:

a) Form 3244, *Payment Posting Voucher*, to process payments.

b) Transaction Code (TC) 640 to indicate an advance payment.

c) TC 670 for any payments received after assessment.

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20.1.9.2.1 (04-22-2011)
Penalty Assessment – Form 8278, Assessment and Abatement of Miscellaneous Civil Penalties

(1). The examiner will enter the dollar amount of the penalty on Form 8278 and attach Form 886-A, *Explanation of Items.*

(2). Form 8278 is the assessment document for the civil penalty module. The penalty assessment is posted to the module using the Penalty Reference Numbers (PRN) reflected on the Form 8278. The PRNs included in section "F" of Form 8278 are the PRNs referred to in Exhibit 20.1.9-3, *Quick Guide for Reference Numbers to Process International Penalty Assessments*. When completing the form, remember to:

a) Include the Continuation Penalty (e.g., PRN 619) on the same Form 8278 as the Initial Penalty amount. Subsequent assessments of the Continuation Penalty should include a zero assessment for the PRN of the Initial Penalty.

b) Prepare a separate Form 8278 for each tax year and IRC section for which a penalty assessment is made.

Continued on next page

c) If a penalty investigation is started and the penalty is waived for reasonable cause or other reasons, appropriately document the workpapers.

(3). Attach Form 886-A to each Form 8278 and include the following information:

a) Name and TIN of the U. S. person required to file the information return.

b) Name and TIN of the entity for which the return was required to be filed (if applicable).

c) Applicable IRC section(s).

d) Computation of penalty.

e) Date the Notice Letter (if applicable) was issued or returns requested.

f) Any other significant correspondence.

g) Date the information or information return was received.

h) Discussion of facts and law as necessary, e.g., reasonable cause for not filing; information on Abusive Transactions (AT) involvement and the promotion; pattern of filing information returns; or other related tax violations (e.g., understatement of income tax related to the failure to file the information returns or failure to file FBAR returns.)

Reminder: These penalties should not be entered on Form 870, Form 4549, Form 4549-A, or any other examination report. For assistance in preparing the international examiners report, refer to IRM 4.60.9, International Examiner's Report.

(4). If the taxpayer agrees to the penalty assessment, note this in your workpapers and on Form 886-A. The taxpayer's signature is **not** required with respect to these penalties.

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20.1.9.2.2 (04-22-2011)
Penalty Case File Assembly and Procedures

(1). Examiners will prepare a separate penalty case file for penalties that contains all relevant information. The "penalty report" consists of Form 8278 and Form 886-A with supporting explanations and computations. For each penalty case file, be sure to:

a) Prepare a separate penalty case file with a separate Form 8278 when penalties will be assessed under more than one IRC section or for more than one tax year.

b) Identify multiple assessments for the same taxpayer.

Reminder: Assessable penalties are assessed on individual taxpayers even when a married filing joint income tax return is filed.

c) Request a current CFOL "I" for the TIN that the penalty is to be assessed on. If other civil penalties are on the module, request CFOL "T" and analyze the accounts. Comment that the penalty should be assessed and is not a duplicate penalty assessment.
Note: Form 5344, *Examination Closing Record*, is not used for a penalty case file.

(2). Prepare the case file as follows:

a) Complete and attach Form 3198, *Special Handling Notice for Examination Case Processing*, to the outside of the penalty case.

b) Penalties are assessed to MFT 13 for entities and MFT 55 for individuals.

c) Indicate the PRN and penalty amounts on Form 3198. For example: "Assess IRC 6038 (*or 6677, etc*.) Civil Penalty indicated on Form 8278. "

(3). Include a copy of the following with your workpapers:

a) The secured information return and/or statements (if filed).

b) The first page of the income tax return with a comment that you inspected the entire return and the required form was not attached.

c) Copy of the Notice Letter with certified mail receipt.

(4). Keep the penalty case file separate from any related income tax cases. Identify related penalty cases as "related returns". Keep a copy of the following in the penalty file:

a) A copy of the information return (if secured - with stamped received date), and

b) Form 8278 with Form 886-A and copies of any relevant documents from the related income tax case file.

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(5). For cases submitted to Appeals, be sure to:

a) Attach Form 4665, *Report Transmittal*, and

b) Include taxpayer's written request for appeal of penalties.

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20.1.9.2.3 (04-22-2011)
Claims or Penalty Abatement Requests

(1). In certain instances, taxpayers will ask for reconsideration of a penalty that has been assessed. The examiner will determine whether all the facts were considered when the penalty was assessed.

Note: Refer taxpayers to the Taxpayer Advocate Service (TAS) (see IRM Part 13, *Taxpayer Advocate Service*) when the contact meets TAS criteria (see IRM 13.1.7, *TAS Case Criteria*) and you can't resolve the taxpayer's issue the same day. The definition of "same day" is within 24 hours. "Same day" cases include cases you can completely resolve in 24 hours, as well as cases in which you have taken steps within 24 hours to begin resolving the taxpayer's issue. Do not refer "same day" cases to TAS unless the taxpayer asks to be transferred to TAS and the case meets TAS criteria. Refer to IRM 13.1.7.4, *Same-Day Resolution by Operations*. When you refer cases to TAS, use Form 911, *Request for Taxpayer Advocate Service Assistance (and Application for Taxpayer Assistance Order)*, and forward to TAS. See also IRM 21.1.3.18, *Taxpayer Advocate Service (TAS) Guidelines.*

(2). In the case of *Wheaton vs. U.S.*, 888 F. Supp. 622 (D.N.J. 1995), the court held that after a penalty is assessed the taxpayer must make "…a 'plausible and believable' assertion that, viewing the facts and law most favorably to the government, the government is certain to fail on the merits of its case. In his affidavit, plaintiff simply denies control over the ten foreign corporations as that term is used in IRC section 6038. Although in theory this allegation may be plausible and believable, the Court does not deem it sufficient to shift the burden of proof to the government."

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3. Payment of claims on penalties or abatement of penalties must be approved by the organizational unit that assessed the penalties. This includes the following situations:
   a) Collection personnel do not have delegated authority to abate or decrease penalties in this chapter assessed by Examination (LB&I, TE/GE or SB/SE).
   b) Campus Exam personnel do not have delegated authority to abate or decrease penalties in this chapter assess by field office Examination.
   c) Delinquent information returns received with a claim or abatement request must be referred to the Examination function that assessed the penalty. The referral package must include the assessment documents.

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20.1.9.3 (04-22-2011)
IRC 6038 – Information Reporting with Respect to Foreign Corporations and Partnerships

(1). IRC 6038(b) provides a monetary penalty for failure to furnish information with respect to certain foreign corporations and partnerships.

(2). The filing requirements apply to both entities which are treated as associations taxable as corporations or as partnerships under Treas. Reg. 301.7701-3.

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20.1.9.3.1 (04-22-2011)
Reporting/Filing Requirements

(1). Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, and Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, are used for reporting purposes.

(2). Foreign Corporations - IRC 6038(a) and Treas. Reg. 1.6038-2(a) require a U.S. person to furnish information with respect to certain foreign corporations. The required information includes foreign corporation entity data, stock ownership data, financial statements, and intercompany transactions with related persons. Other provisions that must be considered include:

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a) A taxpayer meets the requirement by providing the required information on a timely filed Form 5471. A Schedule M attached to Form 5471 is used to report related party transactions. The information is for the annual accounting period of the foreign corporation ending with or within the U.S. person's taxable year. Form 5471 is filed with the U.S. person's income tax return on or before the date required by law for the filing of that person's income tax return, including extensions. Treas. Reg. 1.6038–2(i).

b) Regulations provide exceptions for attaching the Form 5471 to the related income tax return when the return is filed by another shareholder.
i) The taxpayer must provide a copy of the filed Form 5471 when requested.
ii) The non-Form-5471-filer must attach a statement to their income tax return with both the name and TIN of the person filing the Form 5471. If the required return was not filed timely by the other party, the penalty applies.

c) Rev. Proc. 92-70 provides for summary reporting of dormant corporations. By using the summary filing procedure, the filer agrees that it will provide any information required within 90 days of being asked to do so on audit. The monetary penalty or the foreign tax credit reduction (see IRM 20.1.9.4) can be imposed if the information is not provided with the 90 days. Rev. Proc. 92-70 applies in its entirety.

(3). Foreign Partnerships - IRC 6038(a) and Treas. Reg. 1.6038-3(a) require a U.S. person to furnish information with respect to certain foreign partnerships. The required information includes foreign partnership entity data, ownership data, financial statements, and intercompany transactions with related persons. The information is furnished to the IRS as follows:

a) A taxpayer meets the requirement by providing the required information on a timely filed Form 8865.

b) Schedule N, attached to Form 8865, is used to report related party transactions. The information is for the annual accounting period of the foreign partnership ending with or within the U.S. person's taxable year.

c) Form 8865 is filed with the U.S. person's income tax return on or before the date required by law for the filing of that person's income tax return, including extensions. See Treas. Reg. 1.6038-3(i).

(4). Generally, examiners should verify fact of filing by inspecting the original income tax return. When examiners believe that neither Form 5471 or Form 8865 was filed timely, examiners should be sure to secure them and attach copies to the related income tax return.

(5). See IRC 6501(c) (8) for statute of limitations on assessment.

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20.1.9.3.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The CP notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). Failure to File Form 5471 - See Exhibit 20.1.9-6, *Pattern Letter for Failure to File Form 5471.*

(3). Failure to File Form 8865 - See Exhibit 20.1.9-7, *Pattern Letter for Failure to File Form 8865.*

(4). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, Notice of Penalty Charge, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 623**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice.*

b) **BMF** - A CP 215, Notice of Penalty Charge, for penalties assessed on **MFT 13** with **PRN 623**. A sample of a CP 215 notice for this penalty is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice.*

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20.1.9.3.3 (04-22-2011)
Penalty Assertion

(1). An Initial Penalty is asserted by field examiners on Form 8278 using PRN 623 when an examiner determines the taxpayer has not timely filed the required information or has not filed complete and accurate information.

(2). Penalties may be asserted by the Campus for a late-filed Form 1120 that does not have a complete and accurate Form 5471 attached as follows:

a) For IMF, refer to IRM 21.8.1.25, *Form 5471 – Information Return of U.S. Persons with Respect to Certain Foreign Corporations.*

b) For BMF, refer to IRM 21.8.2.21, *Form 5471 – Information Return of U.S. Persons with Respect to Certain Foreign Corporations.*

c) **PRN 599** will be used by the Campus to denote such penalties.

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20.1.9.3.4 (04-22-2011)
Penalty Computation

(1). Initial Penalty - The Initial Penalty is $10,000 per failure to timely file complete and accurate information on each Form 5471 or Form 8865. The penalty is assessed for each form (of each foreign corporation and/or partnership) for each year that was not timely filed with complete and accurate information.

(2). Continuation Penalty - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The Continuation Penalty is $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. These additional penalties are also asserted on Form 8278 using PRN 619. Also note that:

a) The maximum Continuation Penalty for IRC 6038(b) is $50,000 per required Form 5471 or Form 8865.

b) For assessments prior to July 2005, the total penalty amount including the Continuation Penalty was assessed using PRN 623.

(3). The maximum total penalty under IRC 6038(b) is $60,000 per Form 5471 or Form 8865 required to be filed per year (an Initial Penalty maximum of $10,000 plus the Continuation Penalty maximum of $50,000 per return).

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20.1.9.3.5 (04-22-2011)
Reasonable Cause

(1). Initial Penalties - To show that reasonable cause exists, the person required to report such information must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement. For failure to file Form 5471, the written statement must contain a declaration that it is made under the penalties of perjury. Additional information is available for:

a) Form 5471 at Treas. Reg. 1.6038-2(k) (3), and

b) Form 8865 at Treas. Reg. 1.6038-3(k) (4).

(2). Continuation Penalty - There is no reasonable cause exception for this penalty.

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20.1.9.4 (04-22-2011)
IRC 6038(c) – Reduction of Foreign Tax Credit

(1). IRC 6038(c) provides for a reduction in foreign tax credit for a failure to furnish information with respect to a controlled foreign corporation, or a controlled foreign partnership, that is required to be filed under IRC 6038.

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20.1.9.4.1 (04-22-2011)
Reporting/Filing Requirements

(1). For reporting/filing requirements including Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations,* and Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, refer to IRM 20.1.9.3.1, *Reporting/Filing Requirements*.

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20.1.9.4.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). Failure to File Form 5471 - See Exhibit 20.1.9-6, *Pattern Letter for Failure to File Form 5471.*

(2). Failure to File Form 8865 - See Exhibit 20.1.9-7, *Pattern Letter for Failure to File Form 8865.*

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20.1.9.4.3 (04-22-2011)
Penalty Assertion

(1). The foreign tax credit reduction is limited to the **greater** of $10,000 or the income of the foreign entity for the applicable accounting period.

(2). Not every controlled foreign corporation carries a foreign tax credit to the U.S. income tax return.

(3). **Coordination with IRC 6038(b)**. The amount of the IRC 6038(c) penalty is reduced by the amount of the dollar penalty imposed by IRC 6038(b).

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20.1.9.4.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalties**:

a) **Application of IRC 901** - The amount of taxes paid or deemed paid is reduced by 10 percent.

b) **Application of IRC 902 and IRC 960** - The amount of taxes paid or deemed paid is reduced by 10 percent. The 10 percent reduction is not limited to the taxes paid or deemed paid by the foreign corporation with respect to which there is a failure to file information but applies to the taxes paid or deemed paid by **all** foreign corporations controlled by that person.

(2). **Continuation Penalties** - If such failure continues for more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), the amount of the reduction is increased by an additional reduction of 5 percent for each 3-month period, or fraction thereof, during which such failure continues after the expiration of the 90-day period.

(3). **Limitation** - The amount of the foreign tax credit reduction for each failure to furnish information with respect to a foreign corporation may not exceed the greater of:

a) $10,000, or

b) The income of the foreign corporation for its annual accounting period with respect to which the failure occurs.

Note: No taxes may be reduced more than once for the same failure. Also, the regulations have not been updated; where the IRC currently refers to a foreign corporation's "post 1986 undistributed income", the regulations still refer to "accumulated profits".

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20.1.9.4.5 (04-22-2011)
Reasonable Cause

(1). **Initial Penalties** - To show that reasonable cause exists, the person required to report such information must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement. For failure to file Form 5471, the written statement must contain a declaration that it is made under the penalties of perjury. Additional information is available for:

a) Form 5471 at Treas. Reg. 1.6038-2(k) (3), and

b) Form 8865 at Treas. Reg. 1.6038-3(k) (4).

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(2). **Continuation Penalty** - There is no reasonable cause exception for this penalty.

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20.1.9.5 (04-22-2011)
IRC 6038A(d) – Information Reporting for Certain Foreign-Owned Corporations

(1). IRC 6038A provides a penalty for certain foreign-owned domestic corporation failing to report required information or failing to maintain records.

(2). For international examination and processing procedures, refer to IRM 4.60.8.6, *IRC Section 6038A and 6038C Penalties.*

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20.1.9.5.1 (04-22-2011)
Reporting/Filing Requirements

(1). IRC 6038A(a) and Treas. Reg. 1.6038A-2 generally require a reporting corporation to furnish the following information regarding each person who is a related party or had any transaction with the reporting corporation during the taxable year:

a) Name,
b) Business address,
c) Nature of business,
d) Country in which organized or resident,
e) Name and address of all direct and indirect 25-percent shareholders,
f) Name and address of all related parties with which the reporting corporation had a reportable transaction,
g) Nature of relationship of each related party to the reporting corporation, and
h) Description and value of transactions between the reporting corporation and each foreign person who is a related party.

(2). Form 5472, *Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code*, is filed as an attachment to the U.S. income tax return by the due date of that return, including extensions. But, if the reporting corporation's income tax return is not timely filed, Form 5472 nonetheless must be timely filed at the Campus where the return is due. When the income tax return is ultimately filed, a copy of Form 5472 must be attached. In addition:

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a) A taxpayer meets the requirement by timely filing the required information on Form 5472.

b) A separate Form 5472 must be filed with regard to each related party that has reportable transactions with the reporting corporation.

c) A taxpayer is also specifically required to maintain relevant records sufficient to allow determination of the correct tax treatment of the transactions with a related party (as defined in IRC 6038A(c) (2)).

(3). The following exceptions apply:

a) A reporting corporation that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to the record maintenance requirement or the authorization of agent requirement (see IRM 20.1.9.6 below) for such taxable year.

b) If the total value of all gross payments (both made to and received from) foreign related parties with respect to related party transaction for a taxable year is not more than $5,000,000 and is less than 10 percent of its U.S. gross income, the reporting corporation is not subject to the record maintenance requirement and the authorization of agent requirement for those transactions.

Note: These exceptions apply only to the record maintenance requirements and the authorization of agent requirement. These exceptions do **not** apply to the reporting requirements for Form 5472 and the general record maintenance requirements of IRC 6001.

(4). **Reporting Corporation** - A reporting corporation is either a domestic corporation that is 25 percent (or more) foreign-owned or a foreign corporation that is 25 percent (or more) foreign-owned and is engaged in a trade or business within the U.S. at any time during the taxable year.

(5). **25 Percent Foreign-Owned** - A corporation is 25 percent foreign-owned if it has, at any time during the taxable year, at least one direct or indirect 25 percent foreign shareholder (a foreign person owning at least 25 percent of the total voting power of all classes of stock of such corporation entitled to vote, or the total value of all classes of stock of such corporation). The attribution rules of IRC 318 apply. See IRC 6038A(c) (5).

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(6). **Related Party** - The term "related party" means:
  a) Any direct or indirect 25 percent foreign shareholder of the reporting corporation;
  b) Any person who is related (within the meaning of IRC 267(b) or IRC 707(b)(1)) to the reporting corporation or to a 25 percent foreign shareholder of the reporting corporation; and
  c) Any other person who is related within the meaning of IRC 482 to the reporting corporation.

(7). **Foreign Person** - For purposes of IRC 6038A, the term "foreign person" generally means:
  a) Any individual who is not a citizen or resident of the United States;
  b) Any individual who is a citizen of any possession of the United States and who is not otherwise a citizen or resident of the United States;
  c) Any partnership, association, company, or corporation that is not created or organized in the United States or under the law of the United States or any State thereof;
  d) Any foreign trust or foreign estate, as defined in IRC 7701(a)(31); or
  e) Any foreign government (or agency or instrumentality thereof).

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20.1.9.5.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The Computer Paragraph (CP) notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). **Form 5472** - See Exhibit 20.1.9-8, *Pattern Letter for Failure to File Form 5472.*

(3). **Failure to Maintain Required Documents** - See Exhibit 20.1.9-9, *Pattern Letter for Failure to Maintain Required Documents.*

(4). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows.

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a) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 625**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice.*

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20.1.9.5.3 (04-22-2011)
Penalty Assertion

(1). An Initial Penalty is asserted on Form 8278 using **PRN 625** when the examiner determines that a U.S. corporation that is 25 percent foreign-owned during a taxable year has had transaction(s) with a related party and:

a) Has failed to timely file Form 5472, or

b) Has filed a Form 5472 which is inaccurate or incomplete, or

c) Has failed to maintain records of transactions with related parties.

Note: Generally, the records that must be maintained pursuant to IRC 6038A must be maintained within the U.S. However, a reporting corporation may maintain such records outside the U.S. if such records are not ordinarily maintained in the U.S. and if the reporting corporation makes the records available to the Service within 60 days of the request to produce them, or brings the records to the U.S. and complies with the notice requirements under Treas. Reg. 1.6038A-3(f) (2) (i).

(2). **Meeting Records Requirements** - Generally, a taxpayer meets the requirement by complying with the request for books, records, or documents.

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20.1.9.5.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalty** - The Initial Penalty is $10,000 for each failure during a taxable year of a reporting corporation to: (1) timely file a separate Form 5472 with respect to each related party with which it had a reportable transaction during such taxable year, (2) maintain the required records relating to a reportable transaction, or (3) (in the case of records maintained outside the U.S.) meet the non-U.S. record maintenance requirements. Also note that:

a) The Initial Penalty is asserted once per related party per taxable year even if multiple infractions have occurred, e.g., failure to file Form 5472 and failure to maintain records for the same related party.

b) Prior to July 2005, all IRC 6038A assessments were made using PRN 619.

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(2). **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The Continuation Penalty is $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. These additional penalties are also asserted on Form 8278 using PRN 619.

Note: Under certain circumstances, an additional penalty for a taxable year may be imposed if, at a time subsequent to the time of imposition of the Initial Penalty, a second failure is determined and the second failure continues after notification. See Treas. Reg. 1.6038A-4(d)(2) and Treas. Reg. 1.6038A-4(f), Example (2).

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20.1.9.5.5 (04-22-2011)
Reasonable Cause

(1). **Initial Penalty** - To show that reasonable cause exists, the reporting corporation must make an affirmative showing of all the facts alleged as reasonable cause for the failure in a written statement containing a declaration that it was made under the penalties of perjury. See Treas. Reg. 1.6038A-4(b) and note that:

a) Treas. Reg. 1.6038A-4(b)(2)(ii) provides a separate reasonable cause exception for small corporations.

b) This provision states that reasonable cause will be applied liberally when the small corporation had no knowledge of the IRC 6038A requirements, has limited presence in (and contact with) the U.S., and promptly and fully complies with all requests to file Form 5472, and to furnish books and records relevant to the reportable transaction.

c) A "small corporation" for purposes of this section is defined as a corporation whose gross receipts for a taxable year are $20,000,000 or less.

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20.1.9.6 (04-22-2011)
IRC 6038A(e) – Noncompliance Penalty

(1). IRC 6038A provides that a foreign related party must authorize the reporting corporation to act as its limited agent for the purpose of an IRS summons regarding transaction(s) with the related party. IRC 6038A also provides that a reporting corporation must substantially comply in a timely manner to an IRS summons for records or testimony relating to a transaction with a related party. The penalty for failure to authorize an agent or for failure to produce records is described in IRC 6038A (e) (3). For applicable definitions, see IRM 20.1.9.5.1 (4) through (7).

(2). For international examination and processing procedures, refer to IRM 4.60.8.6.7, *IRC Section 6038A(e) Noncompliance Penalty.*

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20.1.9.6.1 (04-22-2011)
Reporting/Filing Requirements

(1). A taxpayer meets the requirement by providing an executed Authorization of Agent within 30 days of request by the Service or, in the case of production of records, by complying with the request for books, records or documents. The penalty is not imposed if a taxpayer quashes a summons other than on grounds that the records were not maintained as required by IRC 6038A (a).

(2). **Statute of Limitations** - The running of any period of limitations under IRC 6501 and IRC 6531 may be suspended as provided in IRC 6038A (e) (4) (D).

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20.1.9.6.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Failure to Authorize as Agent** - See Exhibit 20.1.9-10, *Pattern Letter for Failure to Authorize as Agent.*

(2). **Failure to Maintain Required Documents** - See Exhibit 20.1.9-9, *Pattern Letter for Failure to Maintain Required Documents.*

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20.1.9.6.3 (04-22-2011)
Penalty Assertion

(1). A penalty is asserted when the examiner determines that:
   a) A foreign related party, upon request, fails to authorize the reporting corporation to act as its agent for IRS summons purposes, pursuant to the requirements set forth in Treas. Reg. 1.6038A-5, or
   b) The reporting corporation has failed to respond substantially and timely to a proper summons for records.

(2). The noncompliance penalty follows deficiency procedures and is reflected on the notice of deficiency.

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20.1.9.6.4 (04-22-2011)
Penalty Computation

(1). The noncompliance penalty adjustment permits the Service, in its sole discretion, to adjust the amount of deductions and to adjust cost of goods sold with respect to the related party transaction(s) based upon information available to the Service. See IRC 6038A (e) (3).

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20.1.9.6.5 (04-22-2011)
Reasonable Cause

(1). In exceptional circumstances, the IRS may treat a reporting corporation as authorized to act as agent for a related party for IRS summons purposes in the absence of an actual agency appointment by the foreign related party in circumstances where the actual absence of an appointment is reasonable. See Treas. Reg. 1.6038A-5(f).

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20.1.9.7 (04-22-2011)
IRC 6038B(c) – Failure to Provide Notice of Transfers to Foreign Persons

(1). IRC 6038B(c) provides a penalty for failure to file information with respect to certain transfers of property by a U.S. person to certain foreign persons.

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20.1.9.7.1 (04-22-2011)
Reporting/Filing Requirements

(1). Form 8865 Schedule O, *Transfer of Property to a Foreign Partnership*, and Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*, are used for reporting purposes.

(2). **Foreign Corporations** - IRC 6038B(a) and the regulations issued thereunder require that any U.S. person that transfers property to a foreign corporation (including cash, stock or securities) in an exchange described in IRC 332, IRC 351, IRC 354, IRC 355, IRC 356, IRC 361, IRC 367(d), or IRC 367(e) must report certain information concerning the transfer.
See Treas. Reg. 1.6038B-1(a).

a) Treas. Reg. 1.6038B-1(b)(1) states that notwithstanding any statement to the contrary on Form 926, the form and attachments must be filed with the transferor's tax return for the taxable year that includes the date of the transfer.

b) Taxpayers meet the requirement by filing a complete and accurate Form 926 with their income tax return by the due date of the return (including extensions) at the Campus where they are required to file.

(3). **Foreign Corporations Exceptions** - The penalty does not apply:

a) For transfers of stock or securities to a foreign corporation in a transaction described in IRC 6038B (a) (1) (A) (See Treas. Reg. 1.6038B-1(b)(2)(i) for exceptions in which Form 926 need not be filed for the transfer),

b) For transfers of cash in a transfer described in IRC 6038B (a) (1) (A). Form 926 is only required to be filed under circumstances describe in Treas. Reg. 1.6038B-1(b)(3), or

c) For transfers of cash in a transfer described in IRC 6038B (a) (1) (A). Form 926 is only required to be filed when: 1) immediately after the transfer, such person holds directly, indirectly, or by attribution (determined under the rules of IRC 318(a), as modified by IRC 6038(e)(2)) at least 10 percent of the total voting power or the total value of the foreign corporation; or **2)** the amount of cash transferred by such person or any related person (determined under IRC 267(b)(1) through (3) and (10) through (12)) to such foreign corporation during the 12-month period ending on the date of the transfer exceeds $100,000.

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(4). **Foreign Partnerships** - IRC 6038B (a) and Treas. Reg. 1.6038B-2 require that any U.S. person that transfers property to a foreign partnership in a contribution described in IRC 721 must report certain information concerning the transfer. Also note that:

a) These rules are generally effective with respect to such transfers except as otherwise provided in the regulations.

b) Taxpayers meet the requirements by filing Form 8865 Schedule O, with their federal income tax return by the due date of the return (including extensions) at the Campus where they are required to file.

(5). **Description of Transfer to Foreign Corporations** - A transfer described in IRC 367(a) occurs if a U.S. person transfers property to a foreign person in connection with an exchange described in IRC 332, IRC 351, IRC 354, IRC 355, IRC 356, or IRC 361, provided an exception in IRC 367(a) is not applicable. An exchange described in IRC 332 is subject to IRC 6038B only in limited instances.

Note: A transfer described in IRC 367(d) occurs if a U.S. person transfers intangible property to a foreign corporation in an exchange described in IRC 351 or IRC 361.

(6). **Description of Transfer to Foreign Partnerships** - A transfer described in IRC 721 occurs if a U.S. person transfers property to a foreign partnership under the nonrecognition of gain or loss on contribution rule. Also note that:

a) This rule applies only if a U.S. person holds at least a 10% interest in the partnership immediately before or after the contribution, or

b) The value of the property transferred exceeds $100,000 which includes the value of all property transferred during the 12-month period ending on the date of the transfer (not determined on a calendar year).

Note: The value of any property transferred is the fair market value at the time of its transfer.

(7). **Statute of Limitations** - The HIRE Act amendments to IRC 6501(c) (8), as well as the additional amendments in the Education Jobs and Medicaid Assistance Act, Public Law No. 111-226, make clear that the IRC 6501(c) (8) period applies to the entire return, not just those items associated with the failure to file under IRC 6038B, unless the taxpayer can show reasonable cause. In the case of a taxpayer who demonstrates reasonable cause, only those items related to the failure under 6038B will be subject to the longer period under IRC 6501(c)(8).

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20.1.9.7.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The CP notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). **Form 926** - See Exhibit 20.1.9-11, *Pattern Letter for Failure to File Form 926.*

(3). **Form 8865 Schedule O** - See Exhibit 20.1.9-12, *Pattern Letter for Failure to File Form 8865 Schedule O.*

(4). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, Notice of Penalty Charge, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN)** 676. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 676**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice*.

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20.1.9.7.3 (04-22-2011)
Penalty Assertion

(1). A penalty is asserted on **Form 8278** using **PRN 676** when the examiner establishes that the taxpayer:

a) Is a U.S. person and has made a transfer to a foreign corporation or a foreign partnership as described above,

b) Has failed to timely file Form 926 and attachments, or Form 8865 Schedule O, *Transfer of Property to a Foreign Partnership*, as specified in IRC 6038B, and

c) Has not shown that such failure to comply was due to reasonable cause.

(2). The penalty under IRC 6038B(c) is not subject to deficiency procedures. However, the income tax adjustment for gain recognition **is** subject to deficiency procedures.

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20.1.9.7.4 (04-22-2011)
Penalty Computation

(1). If a U.S. person fails to furnish information in accordance with IRC 6038B and Treas. Reg. 1.6038B-1(f) regarding some or all of the property transferred, then, with respect to such property:

a) It is not considered to have been transferred for use in the active conduct of a trade or business outside the U.S., and gain must be recognized with respect to that property to the extent provided in IRC 367(a) if transferred to a foreign corporation; and

b) The U.S. person must pay a penalty equal to 10% of the fair market value of the property on the date of transfer, not to exceed $100,000, unless the failure was due to intentional disregard.

c) If the property was contributed to a foreign partnership, in addition to the monetary penalty, gain must be recognized by the transferor.

(2). The period for limitations on assessment of tax on the transfer of such property does not begin to run until the date on which the U.S. person complies with the reporting requirements.

Note: IRC 6501(c) (8) applies to the income tax deficiency from items required to be reported under IRC 6038B.

(3). See examples under Treas. Reg. 1.6038B-2.

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20.1.9.7.5 (04-22-2011)
Reasonable Cause

(1). IRC 6038B (c) (2) provides that no penalty shall apply to any failure if the U.S. person shows such failure is due to reasonable cause and not to willful neglect.

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20.1.9.8 (04-22-2011)
IRC 6038C(c) – Information with Respect to Foreign Corporations Engaged in U.S. Business

(1). IRC 6038C makes foreign corporations engaged in U.S. business subject to the same information reporting and record maintenance requirements that apply under IRC 6038A to U.S. 25 percent foreign-owned corporations, and penalizes them in the same manner. See IRM 20.1.9.5.

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20.1.9.8.1 (04-22-2011)
Reporting/Filing Requirements

(1). Foreign corporations subject to this section must maintain any records that were in existence on or after March 20, 1990.

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20.1.9.8.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

BMF - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **Penalty Reference Number (PRN) 603**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice*.

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20.1.9.8.3 (04-22-2011)
Penalty Assertion

(1). An Initial Penalty is asserted on **Form 8278** using **PRN 603** when the examiner determines that the taxpayer failed to furnish or maintain the records to the extent described in IRC 6038A(b) and such other information as the Secretary may prescribe.

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20.1.9.8.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalty** - The Initial Penalty is $10,000 for each taxable year with respect to which such failure occurs.

(2). **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The Continuation Penalty is $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period will be charged. These additional penalties are also asserted on **Form 8278** using **PRN 619**.

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20.1.9.8.5 (04-22-2011)
Reasonable Cause

(1). IRC 6038A (d) (3) provides a reasonable cause exception for the **Initial Penalty** asserted under IRC 6038C.

(2). Reasonable cause does not apply to the **Continuation Penalty.**

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20.1.9.9 (04-22-2011)
IRC 6038C(d) – Noncompliance Penalty

(1). IRC 6038C(d) requires that a foreign related party authorize the reporting corporation to act as its limited agent for summons purposes and requires that the reporting corporation maintain and produce records regarding transactions with the foreign related party.

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20.1.9.9.1 (04-22-2011)
Reporting/Filing Requirements

(1). The requirement is the same as that of IRC 6038A (d). See IRM 20.1.9.5. Foreign corporations subject to this section must maintain any records that were in existence on or after March 20, 1990.

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20.1.9.9.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). Reserved

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20.1.9.9.3 (04-22-2011)
Penalty Assertion

(1). A penalty is asserted when the examiner determines that a foreign related party, upon request, fails to authorize the reporting corporation as its agent for IRS summons purposes, pursuant to the requirements set forth in Treas. Reg. 1.6038A-5.

(2). The noncompliance penalty follows deficiency procedures and is reflected in the notice of deficiency.

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20.1.9.9.4 (04-22-2011)
Penalty Computation

(1). The noncompliance penalty adjustment permits the Service, in its sole discretion, to deny deductions and adjust cost of goods sold with respect to the related party transaction(s) based upon information available to the Service. See IRC 6038A (e) (3).

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20.1.9.9.5 (04-22-2011)
Reasonable Cause

(1). There is no reasonable cause exception for this penalty.

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20.1.9.10 (04-22-2011)
IRC 6039F(c) – Large Gifts from Foreign Persons

(1). IRC 6039F provides reporting requirements for U.S. persons who receive large gifts from foreign persons.

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20.1.9.10.1 (04-22-2011)
Reporting/Filing Requirements

(1). U.S. persons who receive gifts from a foreign individual or foreign estate during the taxable year that in the aggregate exceed $100,000 must file Form 3520, *Annual Return to Report Transactions With Foreign Trust and Receipt of Certain Foreign Gifts*. The threshold for gifts received from foreign corporations or foreign partnerships was originally $10,000, but the amount is adjusted each year for inflation. For example, for 2010, the threshold for a filing requirement was raised to $14,165. The instructions for Form 3520 for any year will have the dollar threshold for the filing requirement for that year. Gifts from foreign trusts are reportable under IRC 6048(c) and failure to report such gifts is subject to penalties under IRC 6677.

(2). Form 3520 is required to be filed separately from the U.S. person's income tax return. Starting with the 2006 processing year, they are filed with the Ogden Campus (prior years were filed in the Philadelphia Campus). The due date for filing is the same as the due date for filing a U.S. person's income tax return, including extensions. A Form 3520 is filed once a year for all reportable gifts within the year with respect to each U.S. person. See Notice 97-34 and the Form 3520 instructions for more specific information.

(3). **Filing Verification** - Form 3520 is processed to Business Master File as MFT 68 under the TIN of the U.S. person who is responsible for filing the return. Because an individual can have a reporting requirement for more than one foreign trust and for foreign gifts, the filing is further identified with a plan number. The steps for filing verification are as follows:

a) Begin research with a BMFOL "I".

b) BRTVU is also available and includes all lines on the return including the foreign trust information that the Form 3520 provides.

c) If the U.S. person is an individual, the TIN will be the SSN + "V" (or "W" if an invalid SSN).

d) If there is no record of this TIN, no returns have been filed.

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(4). Secured Returns - When an examiner secures a delinquent Form 3520, determine if it provides all of the required information and is accurate. If the Form 3520 is incomplete or inaccurate, the examiner must inform the taxpayer that the return is not considered filed until it is complete and accurate. For a complete and accurate Form 3520, perform the following actions:

a) Date stamp each Form 3520 with the date received.

b) Write in **red** across the top of the return – "Delinquent Return – Secured by Exam – Penalty Considered by Exam" (for amended returns, substitute "Amended" for "Delinquent").

c) The original form secured must be sent to:

Internal Revenue Service
1973 North Rulon White Blvd.
Mail Stop 4091
Ogden, UT 84404

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20.1.9.10.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The CP notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 668**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 668**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice.*

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20.1.9.10.3 (04-22-2011)
Penalty Assertion

(1). The penalty is asserted on Form 8278 using **PRN 668** when the examiner determines that:

a) A U.S. person received a reportable gift from a foreign person,

b) Has failed to timely file Form 3520, and

c) Has not shown that failure to file was due to reasonable cause.

(2). **Penalty tax adjustment** - IRC 6039F(c) (1) (A) states that the Secretary will determine the tax consequence of the receipt of such gift if the information is not filed timely. This adjustment is subject to deficiency procedures.

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20.1.9.10.4 (04-22-2011)
Penalty Computation

(1). The penalty for failure to file a timely, complete Form 3520 is 5 percent of the amount of such foreign gift for each month for which the failure continues after the due date of the reporting U.S. person's income tax return (not to exceed 25% of such amount in the aggregate).

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20.1.9.10.5 (04-22-2011)
Reasonable Cause

(1). IRC 6039F(c)(2) provides that no penalty shall apply if the U.S. person shows that the failure is due to reasonable cause and not to willful neglect.

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20.1.9.11 (04-22-2011)
IRC 6039G – Expatriation Reporting Requirements

(1). IRC 6039G was added (redesignated from IRC 6039F by the Taxpayer Relief Act of 1997, P.L. 101-191) by P.L. 105-34.

(2). The American Jobs Creation Act of 2004 (AJCA), P.L. 108-357, made significant amendments to IRC 6039G for individuals who expatriate after June 3, 2004. Individuals who abandon their United States citizenship or lose their U.S. long-term resident status must file Form 8854, *Initial and Annual Expatriation Information Statement.*

(3). The Heroes Earnings Assistance and Relief Tax Act of 2008 (HIRE Act) made additional amendments to IRC 6039G to reflect the enactment of IRC 877A which applies to individuals who abandon their U.S. citizenship or lose their long-term resident status on or after June 17, 2008.

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20.1.9.11.1 (04-22-2011)
Reporting/Filing Requirements

(1). **Pre-AJCA** - For individuals who expatriated prior to June 4, 2004, a Form 8854 was due on the date of expatriation (for U.S. citizens) or the due date of the individual's U.S. income tax return (for long-term residents). There was no annual requirement to file a Form 8854 after the initial form was filed.

(2). **Post-AJCA** - For individuals who expatriated after June 3, 2004, and before June 17, 2008, there is no due date for the initial Form 8854. But their expatriation will not be recognized for tax purposes until a complete initial Form 8854 is filed with the IRS. If the expatriate is subject to the alternate expatriation tax regime (under IRC 877) on the date of expatriation, an annual Form 8854 is then required for each of 10 tax years after the date of expatriation.

(3). **IRC 877A** - IRC 877A generally provides that all property of a "covered expatriate" is treated as sold on the day before the individual's expatriation date. Gain or loss from the deemed sale must be taken into account at that time (subject to a $600,000 exclusion amount which is indexed for inflation annually).

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(4). The following information is required on the initial and annual statements by the individual who expatriates:

a) Taxpayer's TIN,
b) Mailing address of such individual's principal foreign residence,
c) Foreign country in which the individual resides,
d) Foreign country of which the individual is a citizen,
e) Information detailing the income, assets, and liabilities of such individual,
f) Number of days the individual was present in the U.S. during the taxable year, and
g) Such other information the Secretary shall prescribe.

(5). Post-HIRE Act U.S. citizens and long-term residents who expatriate on or after June 17, 2008 must file Form 8854 by the due date of the income tax return (including extensions) for the year that includes their expatriation date. Under certain circumstances, such expatriates must file Form 8854 for subsequent years. For more information, see section 8C of Notice 2009-85.

(6). **Form W-8CE** – "Covered expatriates" who had an interest in a deferred compensation plan, a specified tax-deferred account or a non-grantor trust on the day before the date of expatriation must file a Form W-8CE with each payer of these entities interests. The purpose of the Form W-8CE is to notify each payer that the individual is a "covered expatriate" and is subject to special rules with regard to these entities. Form W-8CE is filed with each payer on the earlier of (a) the day before the first distribution on or after the expatriation date, or (b) 30 days after the expatriation date for each item of deferred compensation, specified tax deferred account or interest in a non-grantor trust.

(7). **"Covered Expatriate"** - An individual is a "covered expatriate" if the individual is either a former citizen or former long-term resident and:

a) The individual's average annual net income tax for the five years ending before the date of expatriation or termination of residency is more than a specified amount that is adjust for inflation ($139,000 for 2008; $145,000 for 2009 and 2010),
b) The individual's net worth is $2 million or more on the date of expatriation, or
c) The individual fails to certify on Form 8854 that they have complied with all U.S. federal tax obligations for the five years preceding the date of the individual's expatriation.

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(8). **Former Long-term Resident** - A former long-term-resident is any individual who was a lawful permanent resident of the United States for all or any part of 8 of the last 15 years preceding the date of expatriation.

(9). **Treatment of Deferred Compensation Plans, Specified Tax-Deferred Accounts and Non-Grantor Trusts** - The "mark-to-market" rules do not apply these entities.

(10). **Deferral of "Mark-to-Market" Tax** – Individuals may elect to defer all or part of the "mark-to-market" tax. This election is not available for individuals who had an interest in a deferred compensation plan, a specified tax-deferred account, or a non-grantor trust on the day before expatriation.

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20.1.9.11.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The CP notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). **Form 8854** - Correspondex letter (C-Letter) 2401C, Failure to File Annual Form 8854 Notification Letter, can be systemically generated for such failure. A sample of the letter, containing approved notice language, can be found through the Office of the Notice Gatekeeper's website at http://gatekeeper.web.irs.gov/snipDetail.aspx?pCP=2401C.

(3). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer.

Example: IMF - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 671**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice.*

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20.1.9.11.3 (04-22-2011)
Penalty Assertion

(1). The penalty is asserted on **Form 8278** using **PRN 671** when the examiner determines that the required Form 8854 is not filed or the individual failed to include all required information on the statement or included incorrect information. The penalty is applied as follows:

a) **Pre-AJCA** - For individuals who expatriated prior to June 4, 2004, if the individual has failed to file a complete, accurate and timely initial Form 8854, the penalty for failure to file the initial Form 8854 is asserted.

b) **Post-AJCA** - For individuals who expatriate after June 3, 2004, the penalty applies for failure to file a required annual Form 8854.
Note: Since there is no due date for the initial Form 8854, there is no penalty associated with such form.

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20.1.9.11.4 (04-22-2011)
Penalty Computation

(1). The penalty computation under IRC 6039G is different for individual who expatriate prior to June 4, 2004, and individuals who expatriate after June 3, 2004, as follows:

a) **Pre-AJCA** - For individuals who expatriated prior to June 4, 2004, if the individual has failed to file a complete, accurate and timely initial 8854, the penalty is the greater of 5% of the tax required to be paid under IRC 877 or $1,000 for each taxable year that the 8854 was not filed.

b) **Post-AJCA** - For individuals who expatriate after June 3, 2004, and before June 17, 2008, the penalty for failure to file an annual 8854 is $10,000 per required annual form.

c) **Post-HIRE Act** - For individuals who expatriate after June 16, 2008, the penalty for each failure to file a required 8854 is $10,000.

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20.1.9.11.5 (04-22-2011)
Reasonable Cause

(1). The penalty, whether Pre-AJCA or Post-AJCA, will not be asserted if the failure to provide the required statement and information was due to reasonable cause and not to willful neglect.

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20.1.9.12 (04-22-2011)
IRC 6652(f) – Foreign Persons Holding U.S. Real Property Investments

(1). IRC 6652(f) provides a penalty for failure to meet reporting requirements under IRC 6039C.

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20.1.9.12.1 (04-22-2011)
Reporting/Filing Requirements

(1). IRC 6039C requires any foreign person holding a direct investment in U.S. real property interests for a calendar year to file a return. The requirement is met by providing information such as name and address, a description of all U.S. real property interests, etc.

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20.1.9.12.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 604**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 604**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice*.

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20.1.9.12.3 (04-22-2011)
Penalty Assertion

(1). The penalty is asserted on **8278** using **PRN 604**. It will apply when it has been established that the foreign person has failed to meet the above requirements.

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20.1.9.12.4 (04-22-2011)
Penalty Computation

(1). IRC 6652(f) (2) provides that the amount of penalty with respect to any failure shall be $25 for each day during which such failure continues.

(2). IRC 6652(f)(3) limits the amount of the penalty determined to the lesser of:
   a) $25,000, or
   b) 5 percent of the aggregate of the fair market value of the United States real property interests owned by such person at any time during such year.

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20.1.9.12.5 (04-22-2011)
Reasonable Cause

(1). IRC 6652(f)(1) provides that no penalty shall apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

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20.1.9.13 (04-22-2011)
IRC 6677(a) – Foreign Trust Information Return – 3520

(1). IRC 6677 provides that persons, who transact with, or own, certain foreign trusts, and who fail to file complete and accurate 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and/or 3520-A, Annual Return of Foreign Trust With a U.S. Owner, may be assessed penalties for such failures unless it is shown that such failure was due to reasonable cause and not to willful neglect. Notice 97-34 provides additional guidance on the filing requirements and penalties.

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20.1.9.13.1 (04-22-2011)
Reporting/Filing Requirements

(1). **3520**, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, is required to be filed by a U.S. person who creates, transfers property to or receives a distribution from, or is considered to be the owner of a foreign trust.

(2). 3520 **must be complete and accurate** to be considered filed. IRC 6048 authorizes the Secretary to prescribe the information required to be reported. Notice 97-34 and the instructions for 3520 describe the information required to be reported.

(3). **U.S. Owners/Creation or Transfer** - IRC 6048(a) generally provides that any U.S. person who directly or indirectly transfers money or other property to a foreign trust (including a transfer by reason of death) must report such transfer on 3520. Generally, a U.S. person who transfers property to a foreign trust is considered the owner of that portion of the foreign trust unless there is no possibility of the trust having a U.S. beneficiary. IRC 679 and regulations more specifically describe individuals who are considered owners of foreign trusts and describe exceptions to the general rule. Other things to consider are as follows:

a) U.S. persons who make transfers to Canadian Registered Retirement Savings Plans (RRSPs) or Registered Retirement Income Funds (RRIFs) are not required to report such transfers on 3520. See Notice 2003-75 and the instructions to 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.*

b) Generally, foreign trusts described in IRC 402(b), IRC 404(a)(4), IRC 404A, or IRC 501(c) (3) are not reportable under these requirements. See IRC 6048(a) (3) (B) (ii) and Notice 97-34.

c) Transfers involving fair market value sales are also not reportable. See IRC 6048(a) (3) (B) (i), Notice 97-34, and IRC 679 and the regulations thereunder for additional information.

(4). Instructions require 3520 be filed by U.S. persons who during the current tax year are treated as the owner of any part of the assets of a foreign trust under the grantor trust rules or if there was a reportable event that occurred during the current tax year. A copy of the owner's statement from 3520-A should be attached to 3520. Even if there is no reportable transaction in a particular year, the U.S. owner must complete and file Part II of 3520. In addition, the U.S. owner must ensure that the foreign trust files 3520-A annually. If the foreign trust fails to file 3520-A, the U.S. owner must complete and attach a substitute 3520-A to their 3520. See IRM 20.1.9.14.

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(5). **Distributions/U.S. Beneficiaries** - IRC 6048(c) generally requires a U.S. person who receives a distribution, directly or indirectly, from a foreign trust, to report on 3520 the name of the trust, the aggregate amount of distributions received from the trust during the taxable year and such other information as the Secretary may prescribe. Refer to Notice 97-34 and the instructions to 3520 for more information. Some examples of reportable and nonreportable distributions are as follows:

a) Distributions to the grantor or owner of the foreign trust must be reported.
b) Distributions from non-grantor foreign trusts must be reported.
c) In certain cases, non-arm's length loans from a foreign trust or the uncompensated use of trust property, will be treated as distributions.
d) Indirect distributions must be reported. For example: Distributions by use of a credit card, where the charges on that credit card are paid or otherwise satisfied by a foreign trust or guaranteed or secured by the assets of a foreign trust must be reported as distributions under IRC 6048(c) for the year in which the charge occurs.
e) Distributions reported as taxable compensation on the income tax return of the recipient are generally not required to be reported.
f) Distributions from Canadian Registered Retirement Savings Plans (RRSPs) or Registered Retirement Income Funds (RRIFs) are not required to report such transfers on 3520. See Notice 2003-75 and the instructions to 8891.

(6). Form 3520 is required to be filed separately from the U.S. person's income tax return. Starting with the 2006 processing year, they are filed with the Campus. They are not attached to the related income tax return. In addition:

a) 3520 is filed once a year for all reportable transactions within the year with respect to each U.S. person and each foreign trust. A separate 3520 is required for each foreign trust.
b) 3520, filed by a U.S. owner, is required to have a copy of the owner's statement from 3520-A attached to the 3520.
c) 3520 is required to be filed by the due date of the income tax return of a U.S. person, including extensions.
d) A separate Form 3520 must be filed by each U.S. person. However, married individuals who file married filing joint may file one Form 3520.

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(7). **Filing Verification** - Form 3520 is on the Business Master File as MFT 68 under the TIN of the U.S. person who is responsible for filing the return. Because an individual can have a reporting requirement for more than one foreign trust, the filing is further identified with a plan number.

a) Begin research with a BMFOL "I". BRTVU is also available and includes all lines on the return including the foreign trust information that the Form 3520 provides.
b) If the U.S. person is an individual, the TIN will be the SSN + "V" (or "W" if an invalid SSN).
c) There is "no record" of this TIN, no returns have been filed.

(8). **Secured returns** - When an examiner secures a delinquent Form 3520, determine if it provides all of the required information and is accurate. If the Form 3520 is incomplete or inaccurate, the examiner must inform the taxpayer that the return is not considered filed until it is complete and accurate. For a complete and accurate Form 3520, perform the following actions:

a) Date stamp each Form 3520 with the date received.
b) Write in **red** across the top of the return – “Delinquent Return – Secured by Exam – Penalty Considered by Exam” (for amended returns, substitute “Amended” for “Delinquent”).
c) The original form secured must be sent to:

Internal Revenue Service
1973 North Rulon White Blvd.
Mail Stop 4091
Ogden, UT 84404

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20.1.9.13.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Letter 3804** - This is an opening **Notice Letter** required to be mailed to a taxpayer under the provisions of IRC 6677(a). This letter is five pages.

(2). **Letter 3943** - This is the closing **acceptance letter** to be utilized after a taxpayer responds and the examiner determines that no penalties will be asserted.

(3). **Letter 3944** - This is the closing **no response letter** to be utilized when a taxpayer either fails to respond to **Notice Letter 3804** or when a taxpayer does not provide a statement of reasonable cause for failing to file such returns.

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(4). **Letter 3946** - This is the closing **reasonable cause rejected letter** to be utilized after a taxpayer responds and the examiner determines that penalties will be asserted.

(5). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 659.** A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice.*

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 659**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice.*

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20.1.9.13.3 (04-22-2011)
Penalty Assertion

(1). An **Initial Penalty** is asserted by field examiners on **Form 8278** using **PRN 659** when the examiner determines that Form 3520 returns were required to be filed and were not timely filed or were not complete and accurate, and that the failure was not due to reasonable cause.

(2). Penalties may be asserted by the Campus for a late-filed Form 3520. Refer to IRM 21.8.2.20, *Information Reporting Under IRC § 6048*. For additional information:

a) For IMF, refer to IRM 21.8.1.24, *Form 3520 and Form 3520-A.*

b) For BMF, refer to IRM 21.8.2.20, *Information Reporting Under IRC § 6048.*

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20.1.9.13.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalty** - Beginning with 2010, the Initial Penalty for failure to file a timely, complete and accurate Form 3520 is equal to the greater of $10,000 or 35 percent of the gross reportable amount. Prior to 2010, the Initial Penalty was 35 percent of the gross reportable amount. The gross reportable amount is defined in IRC 6677(c) as:

a) Contributions to the foreign trust: The gross value of the property involved in the event (determined as of the date of the event) in the case of a failure relating to IRC 6048(a).

b) Distributions from the foreign trust: The gross amount of the distributions in the case of a failure relating to IRC 6048(c).

c) Inaccurate reporting: The penalty applies only to the extent that the transaction is not reported or is reported inaccurately. Thus, if a U.S. person transfers property worth $1,000,000 to a foreign trust, but reports only $400,000 of that amount, penalties may be imposed only on the unreported $600,000. See Notice 97-34.

d) Also, if the return is not filed and the Service assesses a penalty based on available information, additional assessments can be made if additional information is received.

(2). **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The Continuation Penalty is $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. These additional penalties are also asserted on **Form 8278** using **PRN 619**.

(3). The maximum penalty (both Initial Penalty and Continuation Penalty) for each failure to file Form 3520 is the gross reportable amount each year.

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(4). **Example when gross reportable amount determined** - When the Service has evidence that the taxpayer formed a foreign trust and has specifics on the gross reportable amount, a Notice Letter can be issued and, if the taxpayer does not respond, the Continuation Penalty can be assessed. For example, IRS has information that a taxpayer created a foreign trust and transferred $1,000,000 (cash or property) to the foreign trust in the same year and has not filed a return. The taxpayer was issued a Notice Letter and had not filed the return after 35 days following the expiration of the 90-day period:

a) Initial assessment after 125 days from the date of the Notice Letter:
   1. PRN 659 for $350,000 (35% of $1,000,000)
   2. PRN 619 for $20,000
   3. Total assessment: $370,000.

b) If noncompliance continues, additional assessments can be made every 30 days until a complete and accurate Form 3520 is received by the Service, or the penalty equals the gross reportable amount ($1,000,000 for this example):
   1. PRN 659 for $0.00 (zero).
   2. PRN 619 for $10,000 for each 30-day period.

c) If additional information is received that changes the Service's knowledge of the gross reportable amount, additional assessments can be made or the original assessments can be adjusted.

(5). **Example when gross reportable amount CANNOT be determined** - When the Service has evidence that the taxpayer formed a foreign trust but does not have specifics on the gross reportable amount, a Notice Letter can be issued and, if the taxpayer does not respond, the Initial Penalty can be assessed. For example, IRS has information that a taxpayer created a foreign trust and has not filed a return. The taxpayer was issued a Notice Letter and did not respond:

a) Initial Penalty assessment after no response to the Notice Letter will be made on Form 8278 with PRN 659 for $10,000 (the "greater of" threshold amount).

b) If noncompliance continues, but the gross reportable amount cannot be determined, additional assessments (Continuation Penalties) can be made.

c) If additional information is received that changes the Service's knowledge of the gross reportable amount, additional assessments can be made or the original assessments can be adjusted.

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Note: At such time when the gross reportable amount with respect to any failure can be determined, the aggregate penalties imposed under this subsection, with respect to such failure, shall be reduced so not to exceed the gross reportable amount.

(6). **Non-Compliance Tax Adjustment** - IRC 6048(c)(2) provides that any distribution from a foreign trust, whether from income or corpus, to a U.S. beneficiary will be treated as an accumulation distribution includible in the gross income of the distributee if adequate records are not provided to the Secretary to determine the proper treatment of the distribution. This adjustment is subject to deficiency procedures.

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20.1.9.13.5 (04-22-2011)
Reasonable Cause

(1). IRC 6677 provides specific exclusions with respect to the **Initial Penalty** for reasonable cause and Notice 97-34 provides additional information:

a) A taxpayer will not have reasonable cause merely because a foreign country would impose a civil or criminal penalty on the taxpayer (or other person) for disclosing the required information. See IRC 6677(d).

b) Refusal on the part of a foreign trustee to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information, will not be considered reasonable cause.

(2). The fact that the trustee did not provide the taxpayer with a copy of the owner's statement of Form 3520-A is not reasonable cause. The taxpayer owner is also the person responsible for ensuring that the Form 3520-A is filed and that they receive a copy of the owner's statement.

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20.1.9.14 (04-22-2011)
IRC 6677(a) and (b) – Foreign Trusts with U.S. Owners - Form 3520-A

(1). The penalties for failure to file Form 3520-A are similar to the penalties for failure to file Form 3520 except that IRC 6677(b) changes the amount of the initial penalty to the greater of $10,000 or 5 percent of the gross reportable amount. The gross reportable amount is defined in IRC 6677(c)(2) as the gross value of the portion of the trust's assets at the close of the year treated as owned by the U.S. person.

(2). If a foreign trust fails to file Form 3520-A, the penalties are imposed on the U.S. person who is treated as the owner of the foreign trust. The grantor trust rules are in IRC 671 through 679. The U.S. owner may be able to avoid penalties by attaching a substitute Form 3520-A to a timely filed Form 3520.

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20.1.9.14.1 (04-22-2011)
Reporting/Filing Requirements

(1). **Form 3520-A**, *Annual Information Return of Foreign Trust With a U.S. Owner*, is due by the 15th day of the third month after the end of the trust's tax year. Each U.S. person treated as an owner of a foreign trust under IRC 671 through 679 is responsible for ensuring that the foreign trust files an annual return setting forth a full and complete accounting of all trust activities, trust operations and other relevant information as the Secretary prescribes. See IRC 6048(b) (1). In addition, the U.S. owner is responsible for ensuring that the trust annually furnishes such information as the Secretary prescribes to U.S. owners and U.S. beneficiaries of the trust. See IRC 6048(b) (1)(B) and Treas. Reg. 404.6048-1.

(2). IRC 6048 authorizes the Secretary to prescribe the information required to be reported. The instructions to Form 3520-A include all information required to be provided.

(3). U.S. persons who are treated as owners of Canadian RRSPs or RRIFs do not need to ensure that the RRSP or RRIF files a Form 3520-A and do not need to file a substitute Form 3520-A.

(4). Form 3520-A includes an owner's statement for each U.S. person considered to be an owner of a portion of the foreign trust. The owner's statement is required to be provided to each U.S. owner of the foreign trust.

(5). Form 3520-A includes a beneficiary's statement for any distributions made to U.S. persons. The beneficiary's statement is required to be provided to each U.S. beneficiary.

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(6). **U.S. Agent** - A copy of the authorization of agent must be attached to the Form 3520-A and must be substantially identical to the format shown in the instructions. The U.S. agent has a binding contract with the foreign trust to act as the foreign trust's limited agent for purposes of applying IRC 7602, IRC 7603, and IRC 7604 with respect to a request by the IRS to examine records, produce testimony, or respond to a summons by the IRS for such records or testimony.

(7). Trusts without U.S. agents must have the following attached to the Form 3520-A to be considered complete:

a) A summary of the terms of the trust including a summary of oral agreements that the U.S. owner(s) has with the trustee whether or not legally enforceable.

b) Copy of any of the following that have not been previously provided:

1. All trust documents and instruments,
2. Any amendments to the trust agreement,
3. All letters of wishes prepared by the settler,
4. Memorandum of wishes by trustee summarizing the settler's wishes, and
5. Any other similar documents.

(8). **Filing Verification** - Form 3520-A is processed to Master File with MFT 42 as a BMF account under the TIN of the foreign trust. There is a separate extension for this return. It will post as a TC 460 with a date.

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IF, for the foreign trust,	THEN
you have a TIN,	first do a BMFOL "I" to see what returns have been filed. There may be other MFTs posted to that TIN.
and there is a MFT 42, request BMFOL "T" and BRTVU.	request BMFOL "T" and BRTVU (the BRTVU has all lines of the return transcribed).
and there is no MFT 42 posting,	the return has not been filed.
you do not have the TIN	Research NAME for a TIN. Print out the listings of TINs with similar names but no match. Print out the research and include it in your case.

(9). **Secured returns** - When an examiner secures a delinquent Form 3520-A, determine if it provides all of the required information and is accurate. If the Form 3520-A is incomplete or inaccurate, the examiner must inform the taxpayer that the return is not considered filed until it is complete and accurate. For a complete and accurate Form 3520-A, perform the following actions:

a) Date stamp each Form 3520-A with the date received.

b) Write in **red** across the top of the return – “Delinquent Return – Secured by Exam – Penalty Considered by Exam” (for amended returns, substitute “Amended” for “Delinquent”).

c) The original form secured must be sent to:
Internal Revenue Service
1973 North Rulon White Blvd.
Mail Stop 4091
Ogden, UT 84404

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20.1.9.14.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Letter 3804** - This is an opening **Notice Letter** required to be mailed to a taxpayer under the provisions of IRC 6677(a). This letter is five pages.

(2). **Letter 3943** - This is the closing **acceptance letter** to be utilized after a taxpayer responds and the examiner determines that no penalties will be asserted.

(3). **Letter 3944** - This is the closing **no response letter** to be utilized when a taxpayer either fails to respond to **Notice Letter 3804** or when a taxpayer does not provide a statement of reasonable cause for failing to file such returns.

(4). **Letter 3946** - This is the closing **reasonable cause rejected letter** to be utilized after a taxpayer responds and the examiner determines that penalties will be asserted.

(5). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 660**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 660**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice.*

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20.1.9.14.3 (04-22-2011)
Penalty Assertion

(1). An Initial Penalty is asserted by field examiners on **Form 8278** using **PRN 660** when the examiner determines that Form 3520-A returns were required to be filed and were not timely filed or were not complete and accurate, and that the failure was not due to reasonable cause.

(2). Form 3520-A is considered incomplete if:

a) The U.S. owner and/or beneficiary is not timely provided with the required statements.

b) A foreign trust without a U.S. agent does not provide all the required attachments, e.g., summary of the terms of the trust, copies of trust documents or amendments to trust documents, and other required information.

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c) The U.S. agent does not provide information with respect to the trust after a request in writing as required by the terms of the U.S. agent agreement. Reasonable cause does not apply to the penalty in situations relating to a failure to provide information when requested.

d) Form 3520-A does not contain substantially all of the required information on the return, e.g., amount of contributions and distributions, amount deemed as owned by each U.S. person, and balance sheet and income statement information.

(3). Penalties may be asserted by the Campus for a late-filed Form 3520-A. For more information:

a) For IMF, refer to IRM 21.8.1.24, *Form 3520 and Form 3520-A.*

b) For BMF, refer to IRM 21.8.2.20, *Information Reporting Under IRC § 6048.*

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20.1.9.14.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalty** - Beginning with 2010, the Initial Penalty for failure to file a timely, complete and accurate Form 3520-A is the greater of $10,000 or 5 percent of the gross reportable amount at the close of the year treated as owned by the U.S. person. Prior to 2010, the Initial Penalty was 5 percent of the gross reportable amount. See IRC 6677(c). In addition:

a) The initial penalty is computed for failure to provide information or inaccurate reporting. The penalty applies only to the extent that the transaction is not reported or is reported inaccurately. Thus, if a U.S. person reports the value of the account as worth $400,000, but the correct value is $1,000,000, penalties may be imposed on the unreported $600,000. See Notice 97-34.

b) If the return is not filed and the Service assesses a penalty based on available information, additional assessments can be made if additional information is received.

(2). **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The Continuation Penalty is $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. These additional penalties are also asserted on **Form 8278** using **PRN 619**.

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(3). The maximum penalty (both Initial Penalty and Continuation Penalty) for failure to file Form 3520-A is the gross value of the portion of the trust owned by the U.S. person.

(4). When the Service has evidence that the taxpayer formed a foreign trust but does not have specifics on the gross reportable amount, a Notice Letter can be issued and, if the taxpayer does not respond, the Continuation Penalty can be assessed.

Example: IRS has information that a taxpayer transferred $100,000 to a foreign trust defined in IRC 679 in 2004. Therefore, the taxpayer has a requirement to file Form 3520-A for 2004 and for each year thereafter. Unless the taxpayer provides evidence to the contrary or files the required returns, the gross value of the assets owned by the U.S. person is considered to be not less than the $100,000 transferred. The IRS issued a Notice Letter to the taxpayer for 2004 through 2009 and the required returns have not been filed. The taxpayer was issued a Notice Letter and had not filed the return after 35 days following the expiration of the 90-day period. The penalties are computed as follows:

a) Initial assessment after 125 days from the date of the Notice Letter for each year – 2004, 2005, 2006, 2007, 2008, and 2009:

1. PRN 660 for $10,000 (greater of $10,000 or 5% of $100,000 gross reportable amount)
2. PRN 619 for $20,000
3. Total assessment: $30,000 for each of the 6 years or $180,000.

b) If noncompliance continues, additional assessments in 3-month increments can be made until the assessment amount for each year equals the gross reportable amount for each year – 2004, 2005, 2006, 2007, 2008, and 2009 – or until the required returns are filed or the amount of the total assessment for each year equals $100,000:

1. PRN 660 for $0.00 (zero)
2. PRN 619 for $30,000 for each 3-month increment of each year

c) If additional information is received that changes the gross value owned by the U.S. person, additional assessments can be made or the original assessments can be adjusted.

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20.1.9.14.5 (04-22-2011)
Reasonable Cause

(1) IRC 6677 provides specific exceptions with respect to the Initial Penalty for reasonable cause and Notice 97-34 provides additional information. In addition:

a) The U.S. owner is responsible for ensuring that Form 3520-A is filed timely and includes all required information. The failure of the trustee or agent to timely file complete and accurate returns or provide information when requested is not reasonable cause for this penalty.
b) A taxpayer will not have reasonable cause merely because a foreign country would impose a civil or criminal penalty on the taxpayer (or other person) for disclosing the required information. See IRC 6677(d).
c) Refusal on the part of a foreign trustee to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information, will not be considered reasonable cause.

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20.1.9.15 (04-22-2011)
IRC 6679 – Return of U.S. Persons With Respect to Certain Foreign Corporations and Partnerships

(1). IRC 6679 provides a penalty for failure to furnish information and timely file a return required under IRC 6046 or IRC 6046A.

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20.1.9.15.1 (04-22-2011)
Reporting/Filing Requirement

(1). For tax years that began before January 1, 2005, IRC 6679 provided a penalty for failure to furnish information and timely file a return required under IRC 6035. IRC 6035 required a U.S. citizen or resident who was an officer, director or 10 percent shareholder of a foreign personal holding company to file Form 5471 Schedule N by the due date of the taxpayer's income tax return, including extensions.

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Note: Foreign personal holding company provisions have been repealed effective for tax years of foreign corporations beginning after December 31, 2004, and to tax years of U.S. shareholders with or within which such tax year of the foreign corporation ends. Therefore, there is no Form 5471 Schedule N filing requirement for periods after the rules have been repealed.

(2). IRC 6046 requires Form 5471 Schedule O to be filed by the due date of the taxpayer's income tax return, including extensions and must be filed by:

a) A U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired:

   1. Stock which meets the 10% stock ownership requirement with respect to the foreign corporation, or

   2. An additional 10% or more of the outstanding stock of the foreign corporation.

b) A U.S. person who acquires stock in a foreign corporation which, when added to any stock owned on the date of acquisition, meets the 10% stock ownership requirement with respect to the foreign corporation.

c) A U.S. person who acquires stock in a foreign corporation which, without regard to stock already owned on the date of acquisition, meets the 10% stock ownership requirement with respect to the foreign corporation.

d) Each person who is treated as a U.S. shareholder under IRC 953(c) with respect to the foreign corporation.

e) Each person who becomes a U.S. person while meeting the 10% stock ownership requirement with respect to the foreign corporation.

f) A U.S. person who disposes of sufficient stock in the foreign corporation to reduce their interest to less than the stock ownership requirement.

(3). IRC 6046A requires Form 8865 Schedule P, to be filed by the due date of the taxpayer's income tax return, including extensions. The form must be filed by any U.S. person who:

a) Acquires an interest in a foreign partnership,

b) Disposes of an interest in a foreign partnership, or

c) Whose proportional interest in a foreign partnership changes substantially.

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20.1.9.15.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The CP notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). Form 5471, Schedule O - See Exhibit 20.1.9-13, Pattern Letter for Failure to File Form 5471, Schedule O.

(3). Form 8865 Schedule P - See Exhibit 20.1.9-14, Pattern Letter for Failure to File Form 8865 Schedule P.

(4). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

BMF - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 613**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice.*

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20.1.9.15.3 (04-22-2011)
Penalty Assertion

(1). An **Initial Penalty** is asserted on Form 8278 using **PRN 613** when the examiner has established that the taxpayer:

a) Was a U.S. citizen or resident,
b) Had a filing requirement under IRC 6046 or IRC 6046A (or under IRC 6035 for tax years beginning prior to January 1, 2005),
c) Failed to timely file the required information on Form 5471 or Form 8865, and
d) Does not have reasonable cause for the failure to file.

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20.1.9.15.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalty** - The penalty is $10,000 per failure.

Note: For tax years beginning prior to January 1, 2005, the penalty for failure to file Form 5471 Schedule N, *Return of Officers, Directors, and 10% or More Shareholders of a Foreign Personal Holding Company*, was $1,000 per failure and was assessed with PRN 614.

(2). **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties of $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. The maximum Continuation Penalty is limited to $50,000 per failure. These additional penalties are also asserted on Form 8278 using **PRN 619.**

(3). The maximum total penalty under IRC 6679 is $60,000 per failure (an Initial Penalty maximum of $10,000 plus the Continuation Penalty maximum of $50,000 per failure).

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20.1.9.15.5 (04-22-2011)
Reasonable Cause

(1). IRC 6679(a)(1) provides a reasonable cause exception to the **Initial Penalty.**

(2). Reasonable cause does not apply to the **Continuation Penalty.**

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20.1.9.16 (04-22-2011)
IRC 6683 (Repealed) – Personal Holding Company Tax of Foreign Corporation

(1). IRC 6683 provided a penalty for failure to file a true and accurate return of the tax imposed by IRC 541 (personal holding company tax).

(2). P.L. 109-135 repealed IRC 6683 effective for tax years of foreign corporations beginning after December 31, 2004.

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20.1.9.16.1 (04-22-2011)
Reporting/Filing Requirements

(1). Any foreign corporation, with a tax year beginning prior to January 1, 2005, which is a personal holding company (as defined in IRC 542) is subject to personal holding company tax with respect to its income from sources within the U.S. A Schedule PH (Form 1120) must be filed with Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, due on the same date as the Form 1120-F.

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20.1.9.16.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(2). *Reserved*

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20.1.9.16.3 (04-22-2011)
Penalty Assertion

(1). A penalty is asserted when the examiner has established that the taxpayer:
   a) Is a foreign corporation which is a personal holding company with a tax year beginning prior to January 1, 2005,
   b) Has failed to file Schedule PH (Form 1120) to report the tax under IRC 541, and
   c) Does not have reasonable cause for the failure to file.

(2). Statute of Limitations. The personal holding company tax may be assessed at any time within 6 years after the Form 1120-F for such year was filed. See Treas. Reg. 301.6501(f)-1.

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20.1.9.16.4 (04-22-2011)
Penalty Computation

(1). The penalty is computed by multiplying the personal holding company's income tax (including personal holding company tax imposed by IRC 541) by 10 percent. This penalty is subject to deficiency provisions.

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20.1.9.16.5 (04-22-2011)
Reasonable Cause

(1). IRC 6683 provides for such penalties unless it is shown that such failure is due to reasonable cause and not to willful neglect.

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20.1.9.17 (04-22-2011)
IRC 6686 – Information Returns for DISCs and FSCs

(1). IRC 6686 was added by P.L. 92-178 for Domestic International Sales Corporations (DISC) or former Foreign Sales Corporations (FSC).

(2). The provisions for FSCs were repealed by P.L. 106-519 effective generally for transactions after September 30, 2000.

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20.1.9.17.1 (04-22-2011)
Reporting/Filing Requirements

(3). IRC 6011(c) requires DISCs, former DISCs, FSCs, and former FSCs for a taxable year to furnish certain information to the Secretary and to persons who were shareholders at any time during such taxable year, and to keep such records as may be required by regulations prescribed by the Secretary.

(4). The provisions for FSC were repealed by P.L. 106-519 effective generally for transactions after September 30, 2000. In addition:

a) A DISC is required to supply its shareholders such information on Schedule K (Form 1120-DISC), which is due to the shareholders on or before the last day of the second month following the close of its taxable year;

b) A FSC is required to file Form 1120-FSC by the 15th day of the third month after the end of the corporation's tax year; and

c) A DISC or FSC shall keep records supporting its reporting of gross income, deductions, credits and other matters on its income tax forms.

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20.1.9.17.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

BMF - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **Penalty Reference Number (PRN) 605**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16 *Sample CP 215 Notice.*

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20.1.9.17.3 (04-22-2011)
Penalty Assertion

(1). A penalty is asserted by field examiners on **Form 8278** using **PRN 605** when the examiner has established that:

a) The entity is a DISC, or former DISC as defined in IRC 992(a), or the entity is a FSC or former FSC as was defined in IRC 922, and has failed to timely file Form 1120-IC-DISC or Form 1120-FSC, as applicable, or

b) Files a return which does not show the information required under IRC 6011(c), and

c) Does not have reasonable cause for the failure to file or supply information.

(2). Penalties may also be asserted by the Campus for incomplete or inaccurate returns filed. Refer to IRM 3.11.16.32.7, *Civil Penalty - IRC section 6686 of IR Code.*

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20.1.9.17.4 (04-22-2011)
Penalty Computation

(1). The penalty under IRC 6686 is $100 for each failure to supply information (but the total amount imposed for all such failures during any calendar year shall not exceed $25,000) and $1,000 for each failure to file a Form 1120-IC-DISC or Form 1120-FSC.

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20.1.9.17.5 (04-22-2011)
Reasonable Cause

(1). IRC 6686 provides for such penalties unless it is shown that such failure to file or supply information is due to reasonable cause.

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20.1.9.18 (04-22-2011)
IRC 6688 – Reporting for Residents of U.S. Possessions

(1). IRC 6688 applies to any person described in IRC 7654(a) who is required to furnish information and who fails to comply with such requirement unless it is shown that such failure is due to reasonable cause and not to willful neglect.

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20.1.9.18.1 (04-22-2011)
Reporting/Filing Requirements

(1). IRC 6688 provides a penalty for individuals with total worldwide gross income of more than $75,000 who take the position that, for U.S. income tax purposes, they became or ceased to be bona fide residents of a U.S. possession and fail to meet the requirements under IRC 937 by filing Form 8898, Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession. Note that:

a) The instructions to Form 8898 currently specify that the form only needs to be filed by such individuals if they have more than $75,000 in worldwide gross income in the taxable year that they take the position that they became or ceased to be a bona fide resident of a U.S. possession.

b) **U.S. Possessions** - Guam, American Samoa, the Commonwealth of the Northern Mariana Islands (CNMI), the Commonwealth of Puerto Rico, and the U.S. Virgin Islands are U.S. possessions.

c) Form 8898 is filed separately with the Philadelphia Campus (or Campus identified in future instructions), not with the individual's tax return.

(2). The penalty also applies to individuals who have adjusted gross income of $50,000 and gross income of $5,000 from sources within Guam or CNMI and who fail to file Form 5074, *Allocation of Individual Income Tax to Guam or the Commonwealth of the Northern Mariana Islands (CNMI),* as required under Treas. Reg. 301.7654-1(d) for individuals who file U.S. income tax returns.

(3). For tax years 2001 through 2005, Form 8898 must be filed by October 16, 2006.

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(4). Subsequent to 2005, Form 8898 must be filed by the due date (including extensions) for filing Form 1040 or Form 1040NR.

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20.1.9.18.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). The examiner must **follow procedures described in Exhibit 20.1.9-17.**

Note: The CP notices for this penalty require computer reprogramming to incorporate the new Appeals policy per IRM 8.11.5 regarding prepayment appeals of international penalties. See IRM 20.1.9.1.1 (5). Until such time that this notice language can be changed, examiners must follow the procedures described in Exhibit 20.1.9-17.

(2). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

IMF - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 669**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

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20.1.9.18.3 (04-22-2011)
Penalty Assertion

(1). The penalty is asserted on **Form 8278** using **PRN 669** when an examiner determines that:

a) The taxpayer failed to furnish information and file Form 8898 about their residence status of a U.S. Possession, or

b) The taxpayer failed to meet the requirements of Treas. Reg. 301.7654-1(d) and not timely file a properly executed Form 5074, or

c) The taxpayer failed to meet the requirements of IRC 932(a) and Treas. Reg. 1.932-1(b)(1) and not file Form 8689, and

d) Does not have reasonable cause for the failure.

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20.1.9.18.4 (04-22-2011)
Penalty Computation

(1). For tax years ending after October 22, 2004, the penalty is $1,000 for failure to file the respective Form 8898, Form 5074, Form 8689, or for filing incorrect or incomplete information.

(2). For tax years ending before October 23, 2004, the penalty is $100.

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20.1.9.18.5 (04-22-2011)
Reasonable Cause

(1). IRC 6688 provides for such penalties unless it is shown that such failure is due to reasonable cause and not to willful neglect.

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20.1.9.19 (04-22-2011)
IRC 6689 – Failure to File Notice of Foreign Tax Redetermination

(1). IRC 6689 provides a penalty for failure to notify the Service of a foreign tax redetermination with respect to:

a) The amount of foreign taxes paid by or to the taxpayer or accrued pursuant to IRC 905(c), or

b) The amount of adjustment to the deduction for certain foreign deferred compensation plans under IRC 404A (g).

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20.1.9.19.1 (04-22-2011)
Reporting/Filing Requirements

(1). A taxpayer is required to notify the Service of any foreign tax redetermination that may affect U.S. tax liability. If a taxpayer has a reduction in the amount of foreign tax liability, the taxpayer must provide notification by filing Form 1040X or Form 1120X and Form 1116 or Form 1118 by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurred. See Treas. Reg. 1.905-4T (b)(1)(ii). In addition:

a) If a foreign tax redetermination results in an additional assessment of foreign tax, the taxpayer has the 10-year period provided by IRC 6511(d)(3)(A) to file a claim for refund or for additional foreign tax credits. See Treas. Reg. 1.905-4T (b) (1) (iii).

b) When a foreign tax redetermination affects the indirect or deemed paid credit under IRC 902, the taxpayer must provide notification by reflecting the adjustments to the foreign corporation’s pools of post-1986 undistributed earnings and post-1986 foreign income taxes on a Form 1118 for the taxpayer’s first taxable year with respect to which the redetermination affects the computation of foreign taxes deemed paid.

(2). **Redetermination of IRC 404A Deduction** - A taxpayer is required to notify the Service, in the time and manner specified in the regulations under IRC 905, if the foreign tax deduction for deferred compensation expense is adjusted. See IRC 404A (g)(2)(B).

(3). **Foreign Tax Redetermination** - Treas. Reg. 1.905-3T(c) defines a foreign tax redetermination as a change in the foreign tax liability that may affect a U.S. taxpayer’s foreign tax credit and includes:

a) Accrued taxes that when paid differ from the amounts added to post-1986 foreign income taxes or claimed as credits by the taxpayer,

b) Accrued taxes that are not paid before the date two years after the close of the taxable year to which such taxes relate, or

c) Any tax paid that is refunded in whole or in part, and

d) For taxes taken into account when accrued but translated into dollars on the date of payment, the difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

(4). **Statute of Limitations** - IRC 6501(c)(5) independently suspends the normal statute of limitations for additions to tax resulting from a redetermination of foreign tax. IRC 905(c) contains special rules for such changes.

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20.1.9.19.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer.

a) **IMF** - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 570**. A sample of a CP 15 notice for this penalty is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 570.** A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice*.

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20.1.9.19.3 (04-22-2011)
Penalty Assertion

(1). The assessment of the penalty is not subject to deficiency proceedings and is asserted on **Form 8278** using **PRN 570** when the examiner determines that:

a) The taxpayer failed to notify the Service of a foreign tax redetermination, and

b) Does not have reasonable cause for the failure.

Caution: Penalties under IRC 6689 are only applicable to taxable years beginning on or after November 7, 2007 - the date of publication of Temporary Treas. Reg. 1.905-4T in the Federal Register.

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20.1.9.19.4 (04-22-2011)
Penalty Computation

(1). The examiner determines the deficiency attributable to the foreign tax redetermination and to this deficiency is added a penalty computed as follows:

a) 5 percent of the deficiency if the failure to file a notice of foreign tax redetermination is for not for more than 1 month,

b) An additional 5 percent of the deficiency for each month (or fraction thereof) during which the failure continues, but not to exceed in the aggregate 25 percent of the deficiency, and

c) If this penalty applies, then the penalty under IRC 6653(a), relating to the failure to pay by reason of negligent or intentional disregard of rules and regulations, shall not apply.

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20.1.9.19.5 (04-22-2011)
Reasonable Cause

(1). IRC 6689(a) provides for such a penalty unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

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20.1.9.20 (04-22-2011)
IRC 6712 – Failure to Disclose Treaty-Based Return Position

(1). IRC 6712 provides a penalty for failure to disclose a treaty-based return position as required by IRC 6114.

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20.1.9.20.1 (04-22-2011)
Reporting/Filing Requirements

(1). IRC 6114 generally requires that if a taxpayer takes a position that any treaty of the U.S. overrules or modifies any provision of the Code, the taxpayer must disclose the position. A taxpayer meets the disclosure requirement by attaching Form 8833, *Treaty-Based Return Position Disclosure under section 6114 or 7701(b)*, or appropriate successor form to their timely filed tax return (including extensions).

Note: A taxpayer may be able to treat payments or income items of the same type (e.g., interest items) received from the same ultimate payor (e.g., the obligor of a note) as a single separate payment or income item. See Treas. Reg. 301.6114-1(d)(3)(ii) for guidance on rules for single separate payment or income item.

(2). If an individual would not otherwise be required to file a tax return, they must file Form 8833 at the IRS Service Center where they would normally file a return to make the treaty-based return position disclosure under IRC 6114. See Treas. Reg. 301.6114-1(a)(1)(ii) or Treas. Reg. 301.7701(b)-7.

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20.1.9.20.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

a) **IMF** - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 664**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15 *Sample CP 15 Notice*.

b) **BMF** - A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 664**. A sample of a CP 215 notice (for a different penalty) is shown at Exhibit 20.1.9-16, *Sample CP 215 Notice*.

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20.1.9.20.3 (04-22-2011)
Penalty Assertion

(1). The penalty is subject to deficiency proceedings. It is asserted on **Form 8278** using **Penalty Reference Number (PRN) 664** when the examiner determines that:

a) The taxpayer failed to meet the requirements of the IRC 6114 by not filing the proper form, and

b) Does not have reasonable cause for such failure.

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20.1.9.20.4 (04-22-2011)
Penalty Computation

(1). **Individuals** - For an individual, the penalty is $1,000 for each separate treaty-based position taken and not properly disclosed.

(2). **Corporations** - For a C corporation, the penalty is $10,000 for each separate failure to disclose a treaty-based position.

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20.1.9.20.5 (04-22-2011)
Reasonable Cause

(1). IRC 6712(b) provides that the Secretary may waive all or any part of the penalty on a showing by the taxpayer that there was reasonable cause for the failure and that the taxpayer acted in good faith.

(2). Waiver Criteria - Treas. Reg. 301.6712-1(b) provides the authority to waive, in whole or in part, the penalty imposed under IRC 6712 if the taxpayer's failure to disclose the required information is not due to willful neglect. An affirmative showing of lack of willful neglect must be made in the form of a written statement setting forth all the facts alleged to show lack of willful neglect and must contain a declaration by the taxpayer that the statements is made under penalties of perjury.

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20.1.9.21 (04-22-2011)
IRC 6039E – Failure to Provide Information Concerning Resident Status (Passports and Immigration)

(1). IRC 6039E provides a penalty for failure to provide information concerning resident status.

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20.1.9.21.1 (04-22-2011)
Reporting/Filing Requirements

(1). **Passports** - IRC 6039E generally requires that any individual, who applies for a United States (U.S.) passport, must include with such application the taxpayer's TIN (if they have one), any foreign country in which such individual is residing, and any other information as the Secretary may prescribe.

(2). **Immigration** - IRC 6039E generally requires that any individual, who applies to be lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with the immigration laws, must include with such application the taxpayer's TIN (if they have one), information with respect to whether such individual is required to file a return of the tax imposed by Chapter 1 for such individual's most recent 3 taxable years, and any other information as the Secretary may prescribe.

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20.1.9.21.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Passports** - The following letters should be used:

a) **Letter 4318**, *IRC 6039E Initial (Passport)*, and attachment Form 13997, *Validating Your TIN and Reasonable Cause*, will be issued to propose the penalty.

b) **Letter 4319**, *IRC 6039E No Penalty (Passport)*, will be issued after reviewing (and accepting) the information received from the taxpayer to notify the taxpayer that no penalty will be asserted.

c) **Letter 4320**, *IRC 6039E Penalty (Passport)*, will be issued to notify the taxpayer that they did not have reasonable cause and that the penalty will be asserted.

(2). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

IMF - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 679**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice.*

(3). **Immigration** - *Reserved.*

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20.1.9.21.3 (04-22-2011)
Penalty Assertion

(1). The penalty is not subject to deficiency proceedings. It is asserted on **Form 8278** using Penalty Reference Number (PRN) 679 when the examiner determines that:

a) The individual failed to meet the requirements of IRC 6039E by not providing complete passport application information, or

b) The individual failed to meet the requirements of IRC 6039E by not providing complete resident application information.

20.1.9.21.4 (04-22-2011)
Penalty Computation

(1). The penalty is $500 for such failure.

(2). Only one $500 penalty may be asserted per application.

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20.1.9.21.5 (04-22-2011)
Reasonable Cause

(1) IRC 6039E provides for such penalties unless it is shown that such failure is due to reasonable cause and not to willful neglect.
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20.1.9.22 (04-22-2011)
IRC 6038D – Information with Respect to Foreign Financial Assets

(1) IRC 6038D was added by P.L. 111-147, the Hiring Incentives to Restore Employment (HIRE) Act, for any individual failing to disclose information with respect to specified foreign financial assets during any taxable year beginning after March 18, 2010.
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20.1.9.22.1 (04-22-2011)
Reporting/Filing Requirements

(1). A complete and accurate Form 8938, *Statement of Foreign Financial Assets*, attached to a timely filed tax return fulfills the reporting requirements.

(2). The required information for such specified foreign financial assets include:

a) For all accounts/assets, the maximum value of each account/asset during the year.

b) In the case of any account, the name and address of the financial institution in which such account is maintained and the number of such account.

c) In the case of any stock or security, the name and address of the issuer and such information as necessary to identify the class or issue of which such stock or security is a part.

d) In the case of any other instrument, contract or interest:
i. Such information as is necessary to identify such instrument, contract, or interest, and
ii. The names and addresses of all issuers and counter-parties with respect to such instrument, contract, or interest.

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20.1.9.22.2 (04-22-2011)
Penalty Letters/Notice Letters/Notices

(1). **Letter 4618** - This is a **Notice Letter** required to be mailed to the taxpayer under the provisions of IRC 6038D(d).

(2). **Computer Paragraph (CP) Notices** - Once a penalty is identified by the Campus, or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer as follows:

IMF - A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **Penalty Reference Number (PRN) 700**. A sample of a CP 15 notice (for a different penalty) is shown at Exhibit 20.1.9-15, *Sample CP 15 Notice*.

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20.1.9.22.3 (04-22-2011)
Penalty Assertion

(1). An Initial Penalty is asserted on **Form 8278** using **Penalty Reference Number (PRN) 700** when the examiner determines that the taxpayer failed to disclose information on Form 8938 with respect to specified foreign financial assets and to the extent described in IRC 6038D(c) and such other information as the Secretary may prescribe.

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20.1.9.22.4 (04-22-2011)
Penalty Computation

(1). **Initial Penalty** - The Initial Penalty is $10,000 for each taxable year with respect to which such failure occurs.

(2). **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The Continuation Penalty is $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period will be charged. These additional penalties are also asserted on **Form 8278** using **PRN 700**. The maximum Continuation Penalty is limited to $50,000 per failure.

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20.1.9.22.5 (04-22-2011)
Reasonable Cause

(1). IRC 6038D (g) provides that no penalty shall apply if the individual shows that the failure is due to reasonable cause and not to willful neglect. (2)

(2). An individual will not have reasonable cause merely because a foreign jurisdiction would impose a civil or criminal penalty on any person for disclosing the required information.

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Exhibit 4, *Monetary Penalty Case File Assembly Procedures*

Refer to IRM (20)900 for complete details. More than one penalty case file is required when penalties have been proposed under more than one IRC section.

Forms attached to the outside of the monetary penalty case file:

Form 3198 Special Handling Notice

The Form 3198 is attached to the outside of the file and annotated in the "Other" section as follows: "Assess [IRC Section] Civil Penalty as indicated on Form 8278".

Forms and work papers filed within the monetary penalty case file:

Transcript MFT 13 or 55

Penalties not subject to deficiency procedures are usually assessed, collected, and posted to the Master File. The appropriate MFTs are IMF 55 or BMF 13.

Form 8278 Assessment of Miscellaneous Penalties

Form 8278 is the adjustment document for the Civil Penalty Module.
The penalty adjustment is posted to the module using the Reference Codes reflected on the Form 8278. A separate Form 8278 is required for each tax year and code section for which a penalty assessment is made. When additional penalties are to be assessed for continued failure after notification, a Form 8278 must be prepared for each subsequent assessment that is to be made.

Form 3645 Computation of Penalty

A separate Form 3645 must be used for each tax period to be assessed. Under the "Explanation" section, provide a concise explanation of the reason(s) for assertion of the penalty and whether agreed or unagreed. The examiner will consider reasonable cause and record on Form 886-A, if needed, all pertinent information including, facts, law, taxpayer's position and conclusion.

Copy of the Information Return or Statement, plus a copy of page one of the tax return

Delinquent Forms 5471 or 5472

Delinquent forms 5471 or 5472 should have "DELINQUENT RETURN – SECURED BY EXAMINATION – PENALTY CONSIDERED" written across the top in red ink with the date received.

Contact sheet or case history worksheet

Statement of Reasonable Cause

It is advantageous to maintain a copy of the penalty case file documentation with the tax case file (if one exists). This is done in order to assist in making an abatement determination or for other purposes while the penalty case file is still

Continued on next page

being processed.

The penalty case file should be closed via regular case closing procedures.

*Only a COPY of the Form 5471 or 5472 must be sent to Philadelphia Service Center for transcription.

The Examiner should write (in RED) across the top:

"Delinquent Return - Secured By Exam - Penalty Considered" and include the date the form was received.

*The copy of Form 5471 or 5472 should be sent to:

Philadelphia Service Center **NEED TO CHECK ADDRESS. DID THIS CHANGE?**
11601 Roosevelt Blvd.
Philadelphia, PA 19155

ATTN: Form 5471 / 5472 Processing Coordinator
P:DP Unit F, Drop Point DP 335

*There should be similar procedures for Forms 3520, 3520-A, and 8865, but at present the actual contact points are not readily available. If delinquent returns are secured, contact an Offshore Technical Advisor to determined the appropriate actions.

Exhibit 5, *Miscellaneous Penalty Assessment Procedures – Notification*

This document is intended to provide some of the language and other information used in the assessment of miscellaneous penalties under IRC §§ 6038, 6038A, 6038B, 6038C, 6677, and 6679. As these penalties are assessed and collected without regard to the deficiency procedures, they require a special notification of the taxpayer of the pending assessment. The following information was obtained from a variety of sources for suggested language from which to pattern the notification letters being issued to the taxpayers. **Prior to the issuance of any such letter, the revenue agent should 1) ensure the involvement of the International Enforcement Program and 2) involve Area Counsel**.

The information on the following pages includes language for the assessment of penalties for Forms 5471, 5472, 926, and some aspects of Forms 3520 and 3520-A. However, specific language for the initial failure to file penalties for Forms 3520 and 3520-A (the 35% and 5% amounts, respectively) has not been provided. The suggestion would be to include (in a certified letter to the taxpayer), language similar to the following (with appropriate changes made to reflect the correct Code sections and forms):

> The information available to us indicates that you have failed to provide written notice on Form 3520 for the taxable year(s) ending [TAX YEAR(S)], with respect to [NAME OF TRUST], as required by § 6048(a) of the Internal Revenue Code (IRC).
>
> IRC § 6048(a) requires that a grantor or transferor provide written notice to the Internal Revenue Service of the creation of any foreign trust by a U.S. person, or the transfer of money or property by a U.S. person to a foreign trust. Generally, to avoid penalties, Form 3520 must be filed as an attachment to your income tax return by the due date (including extensions) of the return. Part A, Section VIII, Notice 97-34, 1997-1 C.B 422 (attached).

Continued on next page

IRC § 6677(a) provides for a penalty in the amount of 35 percent of the gross amount transferred to the trust during the taxable year if any notice or return required under IRC § 6048 is not timely filed or does not include the required information. The penalty applies only to the extent that the full amount transferred is not reported. For example, if you transferred property worth $1,000,000, but reported only $400,000, penalties may be imposed on $6400,000. If your failure to file Form 3520 continues for more than 90 days after the date on which this letter was mailed to you, the penalty will increase in the amount of $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90-day period. This increase will continue until the form has been filed , but not in excess of the gross amount of distributions received from the foreign trust. up to the gross reportable amount. Both the initial and additional penalties apply to each year in question.

IRC § 6677(d) provides for an exception to the penalty if you demonstrate that reasonable cause exists for failure to file the notice. Note that Section VII of Notice 97-34 provides that reasonable cause does not exist merely because a foreign country would impose a civil or criminal penalty on the trustee (or other person) for disclosing the required information. In addition, refusal on the part of a foreign trustee to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information, will not be considered reasonable cause.

For the Assessment of the $10,000 penalty for failure to comply with the filing requirement of Forms 3520 and 3520-A (under IRC § 6677):

SEND BY CERTIFIED MAIL

Sir or Madam:

We charged you a penalty for each tax year that you didn't file Form 3520 and/or Form 3520-A with the required information on time. The penalty is 35 percent of the gross reportable amount transferred to or distributed from the foreign trust for Form 3520, and/or 5 percent of the gross value of the portion of the foreign trust's assets at the close of the year treated as owned by the U.S. Person for Form 3520-A.

Continued on next page

If you don't comply within 90 days from the date of this notice, the law requires us to charge an additional penalty of $10,000 for each 30-day period (or part of a period) that passes. The penalty will not exceed the gross reportable amount on Form 3520 or the gross value of the portion of the foreign trust's assets treated as owned by you on Form 3520-A.

Appeals Rights

If you believe you have reasonable cause why we shouldn't charge these penalties, you may send us an explanation and ask us to remove or reduce any of the penalties we have charged. Send us a specific explanation for each penalty you wish us to remove or reduce by [Enter Reply Date]. Please indicate any documents that will support your position. If you agree with the penalty, please send the amount due now. We have enclosed an envelope for your convenience.

If you have any questions, you may contact the person named above.

Sincerely yours,
[Manual or Strip in signature]
[Title]

For the Assessment of the Form 3520 Penalty (35%), the following information was obtained with respect to the Closing Unit making the assessment:

The following language is generated by the system when the penalty assessment is made and the "reference number" if placed on the taxpayer's tax module.

Continued on next page

Reference Number	IRC	Title
692	6048	Failure to File Form 3520

We charged you a penalty for each accounting period in which you did not file Form 3520 or did not file it within the time prescribed by law. Per IRC Section 6677(a), the amount of the penalty is 35 percent of the gross reportable amount.

If the information is not received within 90 days from the initial date of notification by the Service, we will charge additional penalties in the amount of $10,000 per 30-day period. The total penalties shall not exceed the gross reportable amount.

If you believe you have reasonable cause and want to contest this assessment, please send an explanation within thirty (30) days from the date of this notice. Otherwise, please send the amount due.

Information as taken from the "Description of Services" Instructions on this Form

In relation to IRC Code Section 6048 regarding MFT 68 assess a penalty of 35% of the gross value of any property transferred to a foreign trust for failure to report the transfer per IRC Section 6677(a).

If the information is not received within 90 days from the initial date of notification by the Service, charge an additional penalty in the amount of $10,000 for each 30-day period (or fraction thereof) that passes until we receive the properly filed form. The maximum amount of penalty is not to exceed the gross reportable amount.

NOTE:

The language of the Form 3520 notification letter for the $10,000 penalty under IRC § 6677 should appropriately mirror the language found for the $10,000 penalty applied for Forms 5471 and 5472 (with changes made to reflect the appropriate Code sections).

For the Assessment of the Form 3520-A Penalty (5%), the following information was obtained with respect to the Closing Unit making the assessment:

Continued on next page

The following language is generated by the system when the penalty assessment is made and the “reference number” if placed on the taxpayer’s tax module.

Reference Number	IRC	Title
693	6048(b)	Failure to File Form 3520A

We charged you a penalty for each accounting period in which you did not file Form 3520A or did not file it within the time prescribed by law. Per IRC Section 6677(b), the amount of the penalty is 5 percent of the gross reportable amount.

If the information is not received within 90 days from the initial date of notification by the Service, we will charge additional penalties in the amount of $10,000 per 30-day period. The total penalties shall not exceed the gross reportable amount.

If you believe you have reasonable cause and want to contest this assessment, please send an explanation within thirty (30) days from the date of this notice. Otherwise, please send the amount due.

Information as taken from the “Description of Services” Instructions on this Form

In relation to IRC Code Section 6048(b) regarding MFT 68 assess a penalty of 5% of the gross value of the trust owned by a US person per IRC Section 6677(b).

If the information is not received within 90 days from the initial date of notification by the Service, charge an additional penalty in the amount of $10,000 for each 30-day period (or fraction thereof) that passes until we receive the properly filed form. The maximum amount of penalty is NOT to exceed the gross reportable amount. *

NOTE:

The language of the Form 3520-A notification letter for the $10,000 penalty under IRC § 6677 should appropriately mirror the language found for the $10,000 penalty applied for Forms 5471 and 5472 (with changes made to reflect the appropriate Code sections).

Continued on next page

For the Assessment of the $10,000 penalty for failure to comply with the filing requirement of Form 5471 (for post-1997 filings):

SEND BY CERTIFIED MAIL

Sir or Madam:

This is to notify you that you failed to file a complete separate annual information return on Form 5471 with respect to [**name of related party**] for the taxable year(s) ending [**tax year**]. Form 5471 is an Information Return of a U.S. Person With Respect to Certain Foreign Corporations required by IRC Section 6038(a).

A penalty of $10,000 will be imposed for the taxable year(s) ending [**tax year**] under IRC Section 6038(b). If you fail to file the information return within 90 days after the date this notice is mailed, an additional $10,000 penalty will be imposed for each 30 day period (or fraction thereof) until the complete Form 5471 has been filed, but in an amount not to exceed $50,000. The penalty is applicable to each year of failure.

Your failure puts you at risk for a penalty in the form of an adjustment that reduces your foreign tax credit under IRC Section 6038(c) for the tax year(s) listed above. The foreign tax credit reduction is reflected in the notice of deficiency for each year of failure. If reasonable cause exists for failure to furnish the information, and you believe this penalty should not be imposed, you are directed to the provisions of Treasury Regulation 1.6038 2(k) (3).

If you have any questions, you may contact the person named above.

Sincerely yours,

[Manual or Strip in signature]
[Title]

The authority to sign such notification letters has been delegated by the Commissioner, Large and Mid Sized Business to International Examiners, GS-13 and above in the following document:

LMSB Delegation Order No. 031, Dated January 22, 2002 (Effective January 1, 2002) Subject: Authority to Sign Notification Letters Under IRC Section 6038 Delegated to: International Examiners GS-13 and above. Authority: Regulation sections 1.6038-2 and 1.6038-3

Continued on next page

For the Assessment of the $10,000 penalty for failure to comply with the filing requirement of Form 5472:

SEND BY CERTIFIED MAIL

Name and current U.S. address of Reporting Corporation	Person to Contact: Telephone Number: Refer Reply to: Date:

Gentlemen:

This is to notify you that you failed to make a separate annual information return on Form 5472 or filed a substantially incomplete Form 5472 with respect to [**name of related party**]. The information return is required by IRC Section 6038A(b).

A penalty of $10,000 will be imposed for the taxable year(s) ending [**tax year**] under IRC Section 6038A(d)(1). If you fail to file the information return within 90 days after the date this notice is mailed, an additional $10,000 penalty will be imposed for each 30 day period (or fraction thereof) until the form has been filed. The penalty is applicable to each year of failure.

If you believe you have reasonable cause why we should not impose this penalty, you are directed to the provisions of Treasury Regulation 1.6038A 4(b).

If you have any questions, you may contact the person named above.

Sincerely yours,

[Manual or Strip in signature]
[Title]

The authority to sign such notification letters has been delegated by the Commissioner, Large and Mid Sized Business to International Examiners, GS-13 and above in the following document

LMSB Delegation Order No. 032, Dated February 12, 2002 (Effective January 1, 2002) Subject: Authority to Sign Notification Letters Under IRC Section 6038A Delegated to: International Examiners GS-13 and above. Authority: Regulation sections 1.6038A-4, 1.6038A-5, 1.6038A-6 and 1.6038A-7

Continued on next page

For the Assessment of the 10% penalty for failure to comply with the filing requirement of Form 926 (for post-1997 filings):

SEND BY CERTIFIED MAIL

Name and current U.S. address
of Reporting U.S. Shareholder

Person to Contact:

Telephone Number:
Refer Reply to:
Date:

Sir or Madam:

This is to notify you that you failed to file a complete separate annual information return on Form 926 with respect to [**name of related party**] for the taxable year(s) ending [**tax year**]. Form 926 is an Information Return of a U.S. Person With Respect to Certain Foreign Corporations and Partnerships required by IRC Section 6038B.

A penalty of 10% of the Fair Market Value of the property transferred will be imposed for the taxable year(s) ending [**tax year**] under IRC Section 6038B(c). The penalty is applicable to each year of failure.

If reasonable cause exists for failure to furnish the information, and you believe this penalty should not be imposed, you are directed to the provisions of Treasury Regulation 1.6038 2(k)(3).

If you have any questions, you may contact the person named above.

Sincerely yours,

[Manual or Strip in signature]
[Title]

The authority to sign such notification letters has been delegated by the Commissioner, Large and Mid Sized Business to International Examiners, GS-13 and above in the following document:

LMSB Delegation Order No. 033, Dated January 22, 2002 (Effective January 1, 2002)
Subject: Authority to Sign Notification Letters Under IRC Section 6038B
Delegated to: International Examiners GS-13 and above.
Authority: Regulation sections 1.6038B-2

Exhibit 6, *International Penalties - Information Return Penalty Case Procedures*

RESEARCH:

- Research IDRS on the US Person responsible for filing the information return.
  - BMFOL / IMFOL "I" for prior penalty assessments on the US person
    - MFT 13 for BMF returns
    - MFT 55 for IMF returns
    - Assessments show as TC 240 with reference numbers for the type of penalty (refer to IRM 20.1)
    - Multiple TC 240s are allowable – you need to verify the reference number and possibly request the penalty file.
  - Research to see if the information return has been filed.
    - A copy should be attached to the originally filed income tax return or amended income return.
    - Issue the Patter Letter to the taxpayer. (See section on Pattern Letters below).
    - Many Information Returns are not processed to IDRS / CFOL.
    - If there is no record of filing, pursue the penalty.

CONSIDERATION FOR FOREIGN INFORMATION RETURNS:

- There is NO statute for assessment of penalties on certain Information Returns.
  - The filing of an income tax return without attaching the required foreign information return(s) has no bearing on the statute for assessment of the penalty. However, a late filed in foreign information return extends the statute of limitations of the items contained on the Information Return.
    - **IRC §6501(c) (8)** extents the statute on for "…assessment of any tax imposed by this title with respect to any event or period to which such information relates" until 3 years after receipt of the information. Generally, this applies from 1997 forward. However, for foreign trust the effective date is 1996 and for transfers to foreign entities and for Form 926 the effective date is 1985.
- All of the related code sections have language that the return is not considered filed until all required information is **correctly** reported.
- A request a foreign information return can be made on a tax period that is not under examination at this time and **does not require the opening of the related income tax return.**

Continued on next page

PATTERN LETTERS:

- You should begin the case by sending the appropriate Penalty Notice Letter (also called "Pattern Letters"). The delegation orders allow the pattern letters to be signed by "Internal Revenue Agents." The pattern letters satisfy the requirements for assessment of additional penalties if returns are not received within 90 days.
- Each entity required to file the information must be given a separate pattern letter for each **type** of form required to be filed (5471, 5472, 8865, 926, etc.).
  - Multiple tax years **may** be shown on one pattern letter.
  - The pattern letters inform the taxpayer that we plan to assess the penalties and give taxpayers an opportunity for reasonable cause consideration.
  - Pattern Letters can be found on the LB&I International Penalties Technical Advisor's webpage.
- The pattern letter must be addressed to the U.S. Person responsible for filing the information returns. In the case of a consolidated income tax return, this may be a subsidiary of the common parent.
- The pattern letter must be sent by Certified Mail, or hand delivered to the taxpayer. The Examiner should keep a copy of the pattern letter signed by the taxpayer when it is hand delivered as proof that it was received. This copy also serves as the date to start the 90 day period for the taxpayer to respond.

ESTABLISH CONTROLS:

Do NOT establish controls until it is determined that the TP does NOT have reasonable cause (if applicable) - see Reasonable Cause section below.

- **Prepare Form 5345D** - the penalty case should be controlled on ERCS (there are no AIMS Controls).
  - Name and address of the U.S. Person (single individual or entity) responsible for filing the return.
  - **Activity Code 506** (the secretary will input the activity code and the MFT P9 and SC 99 will be generated by ERCS).
  - TRACKING CODE – This is the only way to gather information that your penalty case is related to a project. Be sure to use the correct tracking code **if applicable**.
- The case will show up on your 4502 with the TIN of the U S Person, MFT of P9 and the tax year.

Continued on next page

- Charge time to this case as you would to any other case.
  - If you have the related income tax case, post the time spent on the penalty determination to the penalty case.

POWER OF ATTORNEY:

- A separate authorization is needed for the penalty.
  - POA should state “Miscellaneous Penalty Under IRC XXXX”.
  - A POA for the income tax return does NOT cover the penalty issue.

REASONABLE CAUSE CONSIDERATION:

- Request for reasonable cause consideration must be received in writing and under penalty of perjury.
- Evaluate Taxpayer response, review the guidance on reasonable cause consideration.
- **If reasonable cause exists for the failure to file:**
  - Document your determination on Reasonable Cause and close case with NO penalty assessment.
  - DO NOT start the ERCS controls if no penalty exists. The penalty module CANNOT be closed with a $0 assessment. Only start the ERCS controls when you determine that reasonable cause does not exist.
- **If reasonable cause does NOT exist for failure to file:**
  - Determine if any additional foreign information returns are due.
  - Issue a separate Pattern Letter for any additional forms due.
    - Remember, you can request the information returns without starting an income tax examination on the related income tax year.
    - Also, IRC 6501(c)(8) extends the statute of limitations for items disclosed on the information returns until 3 years after it has been filed.
- Requests for additional time to submit returns:
  - There is **no** provision in the law for extension of the 90 Days under IRC sections 6038(b), 6038A, 6677 or 6679.
  - Other code sections may allow additional time – delays by the IRS in responding, extreme hardship, natural disaster or other highly unusual situations.
    - Document any extensions granted and new date.

Continued on next page

- Inform the taxpayer of your decision.
  - Group Manager conference is allowed.
  - The penalties have post assessment appeal rights, if the taxpayer is in disagreement with your decision, advise them of the appeal rights.
    - If your **income tax case** is going to Appeals, include a copy of your penalty file with memorandum to the appeals officer.
    - Prepare the case for closing and assessment.

PREPARE THE CASE FILE:

- Prepare a case file similar to other cases.
- Form 3198 attached to the outside of the case file.
- Inside the case file on the right side of the file (in order from top down):
  - Form 8278 - Assessment of Miscellaneous Penalty (for any penalty).
    - **Use the most current form from forms repository.**
  - Contact Sheet / Activity Record.
  - Statement of Reasonable Cause and determination.
  - Copy of delinquent forms.
  - Copy of Pattern Letters.
  - Work papers / Correspondence.
  - Transcript of MFT 13 or 55 (BMF or IMF).

CLOSING THE PENALTY CASE:

- The penalty is assessed on MFT 13 (Business) or 55 (Individual) and identified by a Reference Number.
  - Penalty reference numbers are found in IRM 20.1.9-3 (11-01-2007).
- **Prepare form 8278** for assessment amount of the penalty:
  - A separate Form 8278 must be filled out for EACH tax year.
  - If Reasonable Cause has been considered and denied indicate on Form 8278 to USE BLOCKING SERIES “52”.

Continued on next page

- **Prepare Form 3198:**
  - Under “Special Features” section of Form 3198 state:
    - **“Assess TC 240 Penalty. Assess $ _________ for Tax Year ________.”**
    - Include a separate statement for **EACH** tax year.
    - State if the case is a **CIC** case.
    - State that Reasonable Cause has been considered and denied.
- Include a copy of the penalty information with your income tax case.
- Penalties which are not subject to deficiency procedures do NOT include an RAR and the taxpayer does NOT sign anything to agree or disagree to penalty.
- The group clerk must update the status of the case to **Status 51** and **Disposal Code 12** before sending the case to Centralized Case Processing.
- The manager MUST approve the ERCS closing before the case is sent to be processed.
- For **LB&I** cases, the penalty case file must be mailed to:

  IRS - Centralized Case Processing
  Scowcroft Bldg
  Mail Stop 4030
  1973 North Rulon White Blvd
  Ogden, UT 84404
- For SB/SE cases, the penalty case file must be mailed to:

  Internal Revenue Service
  MIRSC/CCP
  5333 Getwell Road
  Stop 803
  Memphis, TN 38118
  Fax: 901-786-7106 or 7105

Continued on next page

FOR FORMS 3520 AND/OR 3520A (ONLY):

The original forms secured by Exam must be sent to the following address for processing:

Internal Revenue Service
1973 North Rulon White Blvd.
Mail Stop 4091
Ogden, UT 84404

If you are including a remittance, please use Mail Stop 1999 (in lieu of 4091) and be sure to use overnight mail.

- Date stamp each return with the date received.
- Write in (RED) across the top of the return – “Delinquent Return – Secured By Exam – Penalty Considered By Exam” (for amended returns substitute Amended for Delinquent).

Continued on next page

International Penalties - Training, Audit Tools, and Reference Materials

IRC SECTION 6038 - Information reporting with respect to certain foreign corporations and partnerships

Delegation of Authority [3/1/2007] [6kb]
Delegation Order No. LMSB-193-1 Authority to Sign Notification Letters under IRC sections 6038, 6046 and 6046A.

Pattern Letter for Failure to File Form 5471 [Word, 25kb]
With respect to certain foreign corporations

Pattern Letter for Failure to File Form 8865 [Word, 24kb]
With respect to certain foreign partnerships.

IRC SECTION 6038A - Information with respect to certain foreign owned corporations

Delegation of Authority [3/1/2007] [6kb]
Delegation Order No. LMSB-193-2 Authority to Sign Notification Letters under IRC section 6038A.

Pattern Letter for Failure to File Form 5472 [Word, 25kb]
With respect to certain foreign owned corporations.

Pattern Letter for Failure to Maintain Required Documents [Rev. 3/9/2010] [Word, 24kb]
Pattern Letter for Failure to Maintain Required Records in the U.S. with respect to certain foreign owned corporations.

Authorization of Agent [Word, 39kb]
Pattern Letters and Authorization of Agent form to request U.S. entity Agency Designation. Authorizations for Foreign Parent and Foreign Parent on Behalf of Other Related Entities.

Pattern Letter for Formal Notice of Failure to Authorize an Agent [Word, 23kb]
Formal Notice for Failure to sign Authorization of Agent within the time prescribed by law.

Hot Topic... Authorization of Agent FAQs [11/9/2010] [12kb]
Frequently asked questions regarding Authorization of Agent

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IRC SECTION 6038B - Notice of certain transfers to foreign persons

Delegation of Authority [3/1/2007] [6kb]
Delegation Order No. LMSB-193-3 Authority to Sign Notification Letters under IRC sections 6038B.

Pattern Letter for Failure to File Form 926 [Word, 24kb]
Notice of certain transfers to foreign corporations.

Pattern Letter for Failure to File Form 8865 Schedule O [Word, 24kb]
Notice of certain transfers to foreign partnerships.

IRC SECTION 6040 and 6046A - Returns as to interest in certain foreign corporations and partnerships

Delegation of Authority [3/1/2007] [6kb]
Delegation Order No. LMSB-193-1 Authority to Sign Notification Letters under IRC sections 6038, 6046 and 6046A.

Pattern Letter for Failure to File Form 5471 - Schedule O [Word, 26kb]
Organization or reorganization of foreign corporation and acquisitions and dispositions of its stock.

Pattern Letter for Failure to File Form 8865 - Schedule P [Word, 25kb]
Acquisitions, dispositions, and changes of interests in a foreign partnership.

IRC SECTION 6662(e) and (h) - Accuracy related penalty for IRC section 482 Transfer Pricing adjustments

6662 Flowchart [5kb]
Applicability of penalty.

6662 Pro Forma Request [Word, 36kb]
LB&I Pro Forma IDR for Documentation request per Treas. Reg. 1.6662-6(d). This should be issued on all IRC section 482 Transfer Pricing cases.

Continued on next page

6662 - Transmittal Sheet for Penalty Oversight Committee [Rev. 5/26/2009] [Word, 80kb]
Coversheet for cases to be submitted to the Penalty Oversight Committee. Required for all cases where 6662(e) or (h) penalty is applicable.

6662 - Territory Manager Concurrence Form [Pdf, 27kb]
Required form for every case with a section 482 adjustment which meets the 6662(e) or (h) penalty threshold, but no penalty is being asserted because the TP meets the documentation requirements.

6662 - Pacific Association of Tax Administrators (PATA) Documentation Package [27kb]
Information on uniform documentation requirements for PATA countries (Australia, Canada, Japan and the U.S.). Documentation prepared under these guidelines meet the documentation requirements for each covered country.

IRC SECTION 6048 - Information with respect to certain foreign trusts

Delegation of Authority [3/1/2007] [5kb]
Delegation Order No. LMSB-193-4 Authority to Sign Notification Letters under IRC section 6048 for Form 3520.

Delegation of Authority [3/1/2007] [6kb]
Delegation Order No. LMSB-193-5 Authority to Sign Notification Letters under IRC section 6048 for Form 3520A.

Letter 3804 - Notice Required by IRC 6677 [Rev. 4-2008]
Required to timely file, a complete and accurate Form 3520 and/or Form 3520-A, because information shows a created or had transactions with a foreign trust.

Continued on next page

Miscellaneous International Penalty information

International Penalties in a Nutshell [Rev. 11/29/2010] [Word, 111kb]
An overview of various international penalties with references to forms and Code sections.

Penalty Case Closing Procedures [Rev. 9/29/2010] [17kb]
Instructions on preparing a penalty case file for penalties that are not subject to deficiency procedures. Includes mailing address for penalty file for LB&I and SB/SE.

Form 8278 - Assessment and Abatement of Miscellaneous Civil Penalties [2/2009]
This form is required to process the international penalty case file.

International Technical Training

Chapter 21

Introduction to the Offshore Industry

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 2 hours
Lesson Materials	• Participant Guide • Instructor Power Points
Training Aids	• List any Hand-outs or Job Aids used during lesson

Overview

Introduction

The notion of hiding money offshore to avoid taxation is nothing new. In a letter to President Franklin D. Roosevelt in May of 1937, then Secretary of the Treasury Henry Morgenthau, Jr. described one of the primary tactics being used by wealthy U.S. taxpayers to avoid paying income taxes that would normally be due as "… *setting up foreign personal holding corporations in the Bahamas, Panama, Newfoundland, and other places where taxes are low and corporation laws lax.*"[1]

Many films and novels have involved drug dealers, spies, embezzlers and other nefarious types using the secrecy provided by offshore financial centers to hide their illicit income and avoid detection by law enforcement authorities. While such fictionalizing may be entertaining, the reality is that it is often not that far from the truth. Numerous congressional hearings, government studies, media reports and international efforts have documented the use of offshore financial centers for money laundering, asset protection and tax evasion.

It is essential to understand from the outset that ownership of bank accounts, financial assets and/or foreign entities in offshore financial centers is not illegal. In fact, there are often very legitimate reasons for maintaining such financial structures in today's globalized economy. However, offshore becomes an issue when such accounts, structures or entities are created for, or used in furtherance of, illegal activities and/or tax evasion.

This course will present information about the offshore financial industry, the use of offshore nominee entities to disguise beneficial ownership, the financial structures put in place to obscure the audit trail, and the promoters, facilitators and enablers who are involved in the marketing and servicing of abusive offshore financial products. It will also identify and discuss the potential tax issues, audit techniques, and sources of assistance and information.

Continued on next page

[1] Letter of Henry Morgenthau, Jr., Secretary of the Treasury, to President Franklin D. Roosevelt regarding tax evasion date May 29, 1937, Franklin D. Roosevelt Presidential Library, Hyde Park, New York.

Objectives

At the end of this lesson, you will be able to:

- Identify common offshore entities used to disguise beneficial ownership.
- Identify the four components of an offshore scheme.
- Explain how offshore entities may be used in the evasion of taxes.

Contents

This lesson covers the following topics:

Taxation of U.S. Persons

Taxation of U.S. Person versus Non-U.S. Person

U.S. Persons, as defined by the Internal Revenue Code, are taxed on their worldwide income. IRC §7701(a)(30) defines U.S. person as:

- Citizens and residents of the United States,
- Domestic partnerships and corporations,
- Estates that are not foreign estates as defined by the Internal Revenue Code, and
- Trusts that are subject to primary supervision by a U.S. court and where one or more United States persons have the authority to control all substantial decisions of the trust.

Non-resident alien individuals and foreign corporations are taxed only on certain types of income from U.S. sources and income effectively connected with the conduct of a trade or business in the United States. Non-resident alien individuals are also taxed on gifts of real or tangible property located in the United States. Gifts of intangible property are not subject to the tax. Non-resident alien individuals and foreign corporations are also exempt from tax and withholding on the sale of U.S. securities.

For U.S. estate tax purposes, the estate of a non-resident alien includes real, tangible, and intangible property situated in the United States. Intangible property considered situated in the United States includes stock in U.S. corporations, bond and debt obligations of U.S. obligors, and the taxpayer's share of U.S. partnership assets or U.S. property owned by a trust in which he or she has an interest. (See IRC §§ 2103-2105).

Defining the Issues

Offshore tax schemes and structures attempt to exploit the general rule that non-resident aliens, foreign corporations and partnerships, foreign non-grantor trusts and foreign estates are only taxed on their U.S. sourced or effectively connected income. They take advantage of strict financial secrecy laws afforded by certain Offshore Financial Centers to non-resident foreigners by creating offshore structures that make it appear as if a non-resident person or entity owns certain assets and income when, in fact, they are actually owned and controlled by a U.S. person.

Continued on next page

Defining the Issues (continued)

What are some specific offshore issues that an examiner could encounter?

- A taxpayer may form a foreign corporation or foreign trust in an offshore financial center and use that entity to disguise the true ownership of offshore or domestic bank accounts or other assets thus avoiding taxation of income associated with the accounts or assets.
- A taxpayer may divert taxable income from a U.S. trade or business into an offshore bank account through the use of various offshore devices including:
  - Mirror or Clone Corporations
  - Offshore Merchant Accounts
- A taxpayer may divert taxable income from a U.S. trade or business into an offshore bank account through the use of false deductions schemes including:
  - False Invoicing
  - Reinvoicing
  - Payment of False Loans
- A taxpayer may form a foreign corporation to act as nominee owner of a domestic brokerage account and then claim an exemption from taxation on securities transactions.

Offshore service providers constantly devise new offshore schemes that seek to take advantage of provisions in the tax laws that provide for legal deferment or elimination of certain taxes. However, unlike those who comply with all aspects of such provisions, they attempt to create the appearance of legitimacy while actually providing secrecy of ownership and ensuring the taxpayer continues to own, control and personally enjoy the use of the offshore funds and assets.

Continued on next page

Substance versus Form

At the end of the day, offshore issues often come down to a determination of substance versus form. Often aided by a cadre of professionals, facilitators and enablers, taxpayers will devise offshore schemes that in form create the appearance of legitimacy, while in substance are nothing more than shams.

Example 1

John, a U.S. person, forms a foreign corporation and opens a bank account in an offshore financial center. He funds the account by transferring monies from his U.S. business disguised as deductible payments for non-existent services. He then opens a domestic brokerage account in the name of the offshore entity and claims foreign status by filing a W8-BEN with the broker. John proceeds to buy and sell U.S. securities through the brokerage account with the untaxed profits being directed to his offshore bank account.

The form of the transactions is that a foreign corporation is legitimately conducting the transactions and the profits are being properly exempted from U.S. taxation. The substance of the transaction is that John is the beneficial owner of the foreign corporation and the foreign bank account, and should be paying tax on his capital gains.

Often, complex financial structures and arrangements are designed to create the impression of legitimacy. Multiple domestic and foreign corporations, trusts and offshore financial centers may be used to obscure what is really taking place. Layer upon layer of nominee entities, accounts and assets may be created to disguise true ownership. However, at the core of every offshore scheme will be an arrangement that allows the taxpayer to ultimately retain personal control over the accounts, funds and/or assets.

Continued on next page

Exercise 1

Circle any of the following which could be part of an abusive offshore tax evasion scheme:

a. Formation of a corporation in an offshore financial center
b. Formation of a corporation in the United States
c. Formation of a trust in an offshore financial center
d. Formation of a trust in the United States

Answer:

All could be part of an offshore tax evasion scheme. Offshore tax schemes can involve multiple layers of nominee entities that could include both offshore and domestic entities.

International versus Offshore

Why does it matter

As previously stated, offshore service providers are trying to create the impression of legitimacy for the offshore structures and products they create. They often market their financial products to U.S. taxpayers as being perfectly legal and in accordance with IRS rules and regulations even when they clearly are not.

They routinely point to the decision in Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934) to support their position. In writing for the majority, Judge Learned Hand stated "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury." Offshore service providers contend this statement verifies that U.S. persons can use nominee offshore corporations, trusts and other entities to structure their financial affairs in such a way as to avoid paying U.S. taxes.

What they do not point out is that in this case the court actually ruled in favor of the government and against the taxpayer who had structured a taxable distribution of property in the form of a corporate reorganization in an attempt to make it a tax-free reorganization. The court refused to recognize the "reorganization" because there was no real business purpose for it, which is not unlike the structures that offshore service providers routinely put in place to obscure beneficial ownership of foreign bank accounts and assets.

Offshore service providers also leave out the part of the same quotation where Judge Hand went on to state: "To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations'."

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So what is the difference

The term “offshore” does not, in and of itself, mean that something sinister or nefarious is taking place. To many, “offshore” is simply the opposite of “onshore” and the word is essentially synonymous with the words “foreign” and “international.”

The offshore industry actively encourages this blending of the terms to create the appearance of legitimacy for the abusive financial products they offer. By blurring the distinction between “international” and “offshore,” they are able to promote their abusive tax avoidance products as “international tax planning strategies” rather than the shams that they often are. Within the context of U.S. taxation, “International” generally refers to the use of legal provisions of the tax code to defer or eliminate otherwise required federal taxes where cross-border taxation issues are involved. These provisions are usually intended to mitigate double taxation or to defer U.S. taxation of income earned by a legitimate foreign business enterprise until it is brought into the United States, and they often involve highly technical issues that come with extensive disclosure, filing and reporting requirements related to the foreign activity.

“Offshore” on the other hand, is generally used to refer to the use of financial secrecy laws and practices of certain financial secrecy jurisdictions by foreign nationals to conceal their identities, account transactions and assets from taxing authorities, law enforcement and creditors. This secrecy is often enhanced through the use of nominee entities, such as trusts and foreign shell corporations, which are created solely to further disguise true beneficial ownership. While there can be some legitimate reasons for establishing offshore accounts and entities, offshore service providers often use these financial secrecy laws in combination with nominee entities and low, or no, tax rates to create and market tax evasion schemes and asset protection schemes to U.S. taxpayers.

The Offshore Financial Industry

The Players

The Offshore Financial Industry is made up of three distinct groups.

- **Offshore Financial Centers**
- **Financial Institutions**
- **Offshore Professionals**

Offshore Financial Centers provide financial secrecy and other advantages to non-citizens domiciled outside the secrecy jurisdiction. Often, they also provide favorable laws for corporations, trusts, foundations and other legal entities or arrangements as well as low or no taxation on business conducted outside their borders. While there is no definitive list of Offshore Financial Centers, the International Monetary Fund has compiled a list of 46 countries it considers Offshore Financial Centers.[2] See Exhibit 1.

Financial Institutions provide the bank accounts, brokerage accounts, investment vehicles, insurance policies, etc. that are at the core of an abusive offshore tax scheme. Comprised of banks, brokerage firms and insurance companies, certain financial institutions, both domestic and foreign, actively promote offshore investment and assist in the creation and execution of the offshore schemes. They facilitate the covert ownership and control of offshore and onshore assets and may assist by providing documents and statements needed to hide true ownership.

Offshore Professionals include lawyers, accountants, brokers, promoters, trust companies, bankers, private bankers, financial advisors, wealth managers and others who promote, facilitate or enable the abusive offshore schemes. Offshore professionals, working closely with financial institutions and other offshore professionals often create elaborate structures and investment vehicles intended to appear legitimate while obscuring ownership and control of the accounts and assets involved.

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[2] Offshore Financial Centers, A Report on the Assessment Program and Proposal for Integration with the Financial Sector Assessment Program, May 8, 2008, Page 13.
http://www.imf.org/external/np/pp/eng/2008/050808.pdf

The Players (continued)

Working in cooperation with one another, Offshore Financial Centers, Financial Institutions and Offshore Professionals create an environment of anonymous ownership of financial assets and discreet control that are the backbone of abusive offshore schemes.

The Veil of Secrecy

As stated earlier, anonymous ownership of financial assets and discreet, but effective, control are at the core of abusive offshore tax schemes. Anonymity is achieved in layers through implementation of:

- Civil laws
- Criminal Laws
- Bank Policy
- Industry Practices

Offshore Financial Centers have enacted strict financial secrecy laws that prohibit banks and bank employees from disclosing financial information for any reason. Some secrecy jurisdictions, such as Switzerland and Liechtenstein, have made disclosure of financial information a criminal offense punishable by incarceration. Individual bank policies and industry practices also contribute to fostering anonymous ownership of financial accounts and assets within secrecy jurisdictions. For example, in order to ensure that a client request for information is voluntary and not being forced by a summons, subpoena or court order, some offshore banks assign passwords to accounts that must be included on all correspondence and communications or the bank will not respond.

This culture of secrecy that has developed around Offshore Financial Centers and the banks, brokerage firms and offshore professionals that promote them make secrecy jurisdictions attractive to those who seek to conceal the true ownership and control of offshore assets, the relationship among entities and the true nature of offshore financial transactions.

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The Veil of Secrecy (continued)

IRS has made much progress in piercing this veil of secrecy by securing Tax Information Exchange Agreements (TIEA) with a number of Offshore Financial Centers. However, the utility of these agreements is often limited by a requirement that IRS must already know about the existence of an offshore account, and have the ability to identify it with a high degree of specificity (e.g., account owner name and address, bank name, bank account number, etc.).

IRS has also had significant success in penetrating the veil of secrecy through enforcement measures such as the use of John Doe summonses that seek to identify U.S. owners of offshore accounts and assets by issuing summonses to U.S. based third parties who are in possession of records that will identify their U.S. owners.

Common Entities Used

Anonymity and discreet control are further enhanced through the use of nominee offshore entities such as foreign corporations, trusts and partnerships. These foreign entities are created as part of the overall structure to layer and obscure the beneficial ownership of the funds or assets while retaining covert control. Often, they are nothing more that shell corporations and sham entities although they may appear legitimate at first. Sometimes they are sold as prepackaged products known as “Shelf Corporations” that come with preselected names, foreign mailing addresses, nominee officers and directors, existing corporate minutes and more, all of which are fictitious.

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Common Entities Used (continued)

Examples of common offshore entities that may be used in the creation of an offshore financial structure include:

- International Business Company (IBC)
- Personal Investment Company (PIC)
- Protected Cell Company (PCC)
- Foreign Trusts
- Foreign Partnerships
- Foundations
- Anstalt
- Stiftung
- Societe Anonyme (SA)
- Aktiengesellschaft (AG)
- Fideicomiso

Remember that the mere ownership or use of an offshore entity does not automatically mean the taxpayer is involved in tax avoidance activities, as these same entities may be used in the furtherance of legitimate international trade. However, examiners should be particularly cautious when such entities are domiciled in known tax havens and are being used by individual taxpayers for no apparent business purpose other than disguising ownership. You will learn more about these and other offshore entities in later lessons.

Exercise 2

True or False

Dave, an online retailer, is the owner of an offshore IBC that sells sporting goods over the Internet. The fact that Dave uses an offshore IBC clearly demonstrates that he is involved in an abusive offshore tax scheme.

Answer: False. Ownership or use of an offshore entity does not automatically mean the taxpayer is involved in tax avoidance activities. IBCs and other offshore entities may be used in the furtherance of legitimate international trade.

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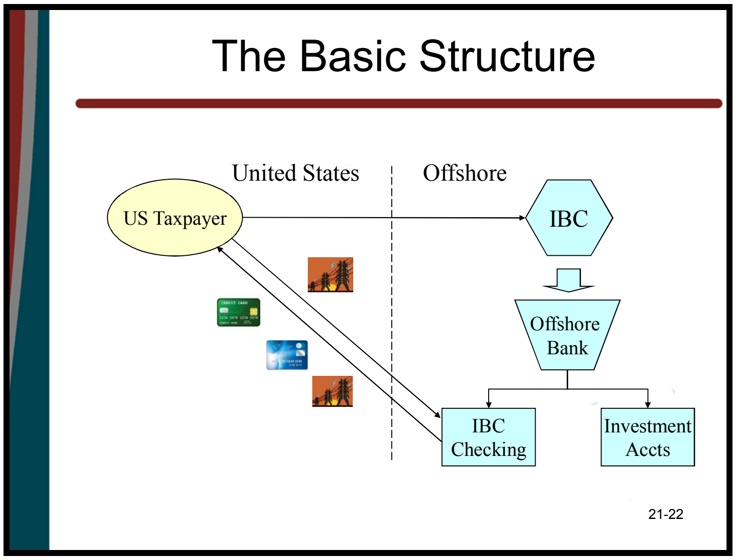
The Basic Structure

The basic structure of an offshore scheme involves the creation of an offshore corporation, trust, foundation or other entity to act as nominee owner of the accounts and/or investments.

Example 2



The offshore entity will then be used to open one or more accounts at a bank usually located in an offshore financial center. Sometimes the accounts will be located in the same offshore jurisdiction as the foreign entity while at other times they will not. Once established, the taxpayer will transfer funds to the offshore accounts using a variety of offshore schemes you will learn about in later lessons. Often times, the funds will simply be wire transferred to the accounts through the use of a U.S. bank or a domestic subsidiary or branch office of the offshore bank.

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The Basic Structure (continued)

Banks generally provide for access to the funds by issuing the beneficial owner a debit card or credit card that is linked to the offshore bank account. The beneficial owner can then use the debit card to withdraw funds at any ATM or bank, or use the credit card to pay for personal purchases of goods and services. For larger withdrawals, the offshore bank will wire transfer funds to an account at a bank in the United States or send the beneficial owner a check drawn on the offshore bank's U.S. correspondent account.

Offshore banks impose minimum relationship balances or minimum deposit requirements to open an account. At exclusive private banks, the minimum relationship is usually measured in the millions or hundreds of thousands of U.S. dollars. At smaller banks, minimum deposit requirements may represent a multiple of the credit limit being provided so as to ensure the account has sufficient funds available to cover the costs of any credit card purchases.

While the appearance being created through this structure is that any funds on deposit, and the investments and other assets being held, are owned by a foreign corporation, the reality is that the U.S. taxpayer will beneficially own the funds and will continue to have control over the funds and enjoy personal use of and unrestricted access to the funds.

To further obscure and disguise the beneficial ownership of an offshore account, additional offshore entities such as a foreign trust may be inserted between the foreign corporation and the beneficial owner as an additional layer of secrecy.

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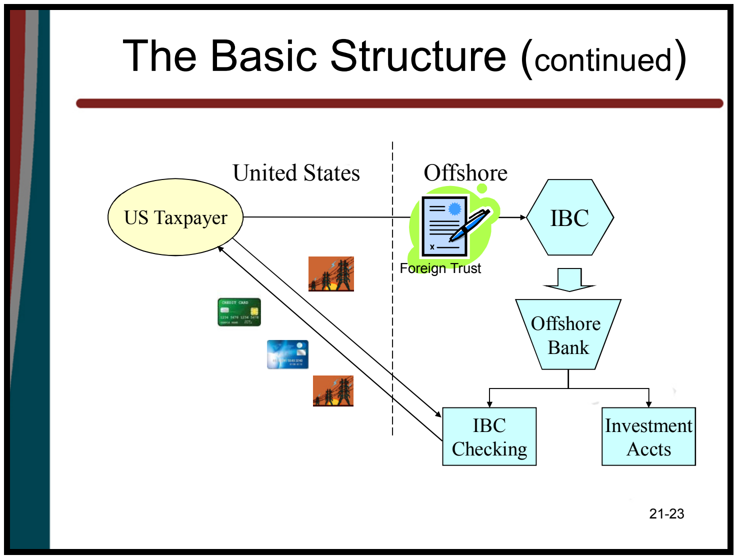
The Basic Structure (continued)

Example 3



More complex offshore structures can be created by placing each of the offshore entities in different offshore financial centers. For example, the trust could be located in the Isle of Mann, the IBC could be located in the British Virgin Islands and the bank accounts could be located in Hong Kong. Not only does this create three separate layers of disguised ownership, but it also requires that the secrecy laws of three distinct offshore financial centers be pierced. Even more complexity can be created by establishing additional trusts and IBCs to further layer and obscure beneficial ownership.

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The Basic Structure (continued)

An actual case study presented in a report by the U.S. Senate Permanent Subcommittee on Investigations entitled “Tax Haven Abuses: The Enablers, the Tools and Secrecy” included a chart demonstrating how two brothers controlled, personally enjoyed and beneficially owned millions of dollars in securities, real estate, business ventures, art and jewelry through a single offshore structure that involved the use of 19 offshore trusts, 39 offshore corporations and multiple offshore jurisdictions.[3]

The creation and marketing of such offshore structures has become big business for the offshore players. Offshore jurisdictions derive income from licensing and regulatory fees associated with the IBCs and trusts, offshore banks derive income from the associated banking fees and offshore professionals derive income from creating, marketing and servicing the structures.

For example, according to various published reports, the British Virgin Islands, a Caribbean island with a total land mass of 56 square miles and a total population of approximately 19,000 people had registered more than 700,000 IBC’s in the island as of 2008 that generated over $103 million dollars of licensing fees annually. As of September of 2010, over 456,000 of these companies remained actively registered with approximately 50,000 new registrations occurring each year.[4]

Similarly, according to a report by the Cayman Islands Monetary Authority, as of December 31, 2010, there were 246 licensed banks in the Cayman Islands. Of these, 229 (93% of the total) were licensed as “Class B” banks meaning generally that the banks can only conduct international banking business with clients located outside of the Cayman Islands. In addition, there were 8 money service providers and 44 nominee trust service providers licensed in the islands.[5]

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[3] Tax Haven Abuses: The Enablers, The Tools and Secrecy, Vol. 1, Page 622, Report of the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, United States Senate, August 1, 2006.
[4] BVI Financial Services Commission Statistical Bulletin, Volume 20, September 2010. http://www.bvifsc.vg/Publications/StatisticalBulletin/tabid/200/Default.aspx
[5] Cayman Islands Monetary Authority, Number of Licensees & Other Entities Supervised by the Banking Supervision Division, December 31, 2010. http://www.cimoney.com.ky/stats_reg_ent/stats_reg_ent.aspx?id=200&ekmensel=e2f22c9a_14_72_200_6

The Four Components

There are four basic components to an offshore scheme:

- Devise an overall offshore plan
- Covertly transfer funds and assets offshore
- Control the funds and assets transferred offshore
- Access or repatriate the offshore funds when needed

Devise an Overall Offshore Plan

Devising an overall offshore plan can be as simple as searching the Internet for an offshore tax scheme or as complex as retaining the services of lawyers, accountants, private bankers, financial advisors and/or others to create a custom designed offshore structure tailored to meet one's specific needs.

Offshore promoters, particularly those that operate over the Internet or from known tax havens, generally offer prepackaged products and structures for a fee that may include shelf corporations and "do it yourself kits" to produce paperwork and false documentation when needed. High-wealth individuals, on the other hand, will have complex plans devised by a cadre of domestic and foreign lawyers, accountants, private bankers and financial advisors that may involve multiple accounts, entities and secrecy jurisdictions.

Notwithstanding the wealth of the taxpayer or who devises the plan, essential to any plan will be an arrangement that provides the ability to covertly move funds to an offshore financial center while ensuring that control over the funds is retained, unrestricted access to the funds is provided and the anonymity of the beneficial owner of the funds is protected.

Covertly Transfer Funds and Assets Offshore

Taxpayers use a variety of techniques and devices to conceal transfers of money or other property to offshore entities. Some may be as simple as skimming income from a domestic business or generating false deductions, and then covertly sending the funds to an offshore bank account held in the name of a nominee offshore entity.

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The Four Components (continued)

Common devices include:

- creation of an offshore business bank account,
- fictitious invoicing for payments characterized as legal, consulting or management services,
- false loans and gifts received,
- interest paid on non-existent loans,
- insurance premiums paid to an offshore “insurance company,”
- deferred compensation structures,
- factoring of accounts receivables,
- creating domestic trusts to divert income disguised as deductible expenses or as distributions to an apparently unrelated beneficiary,
- transfers of assets in exchange for private annuities or notes.

Due to post-9/11 changes in money transfer laws and increased awareness and compliance by U.S. entities and offshore jurisdictions in enforcing money laundering laws, the physical transportation of currency is no longer as easy as it once was. Consequently, the use of wire or bank transfers, along with checks and other monetary instruments have become the simplest methods of moving money.

Control the Funds and Assets Transferred Offshore

Taxpayers also need to devise a way to exercise and maintain control over the funds or other assets once they have been transferred offshore. For IBCs and other corporate type entities this control is usually established through bank Know Your Customer programs that clearly identify and document the actual identity of the beneficial owner of the funds or assets. For foreign trusts, control is generally established through powers of attorney, a letter of wishes or the appointment of a trust protector who will secretly operate under the direction of the grantor or settlor of the trust.

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The Four Components (continued)

Many offshore banks and trust providers also provide discreet ways for account owners to manage their accounts and provide instructions while avoiding detection. These may include the use of secure means of communication such as encrypted emails; hold mail facilities, use of third parties, fictitious written statements, unique codes or passwords and more. Some offshore banks have gone so far as to refuse to comply with any instructions received from an account owner that was transmitted using U.S. jurisdictional means (e.g., telephone numbers, fax machines, post offices, etc. located in the United States).

Access or Repatriate the Offshore Funds When Needed

The last component of an offshore scheme involves the ability to access or repatriate the offshore funds when needed. At some point, the taxpayer, a close family member, the taxpayer's heirs, or a related entity will want to access the funds on deposit in the offshore accounts.

The taxpayer could certainly travel to the offshore location and physically withdraw funds in the form of currency or check, but this would create safety and security issues, not to mention the inherent difficulties and potential legal consequences involved in attempting to covertly transport the funds across U.S. borders. Alternatively, the taxpayer could have the funds wire transferred to a correspondent bank account of the offshore bank located in the United States for delivery to the taxpayer in the form of currency or a check drawn on the correspondent bank. This approach would involve the creation of U.S. banking records and increased risks of detection so transactions need to be disguised as legitimate non-taxable transactions.

Examples include:

- gifts from foreign relatives
- inheritances from distant foreign relatives
- loans from unidentified foreign lenders
- educational grants or scholarships
- insurance proceeds from foreign insurance companies

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The Four Components (continued)

The most common form of repatriation is through the use of debit cards or credit cards that are linked to the offshore accounts. They provide an easy and covert way to anonymously access offshore funds. Cash can simply be withdrawn at any ATM or at any bank by using the offshore debit card. Purchases of goods and services can be paid for using an offshore credit card with the funds needed to settle the monthly bill being automatically transferred from the offshore account.

Exercise 3

Eddie is the beneficial owner of an offshore bank account that contains untaxed income skimmed from his nationally known chain of delicatessens. When his daughter gets accepted to an Ivy League University, Eddie arranges for his daughter to win a scholarship contest that will be funded by monies from his offshore account. This is an example of which of the four components of an offshore scheme?

Answer:

Access or Repatriation of the Offshore Funds When Needed

Offshore Terminology

Overview

To understand the Offshore Financial Industry, it is necessary to become familiar with some of its unique terms. While not all inclusive, the following list contains definitions of many of the more common terms used.

Offshore

When used in a financial context, and when referring to a country, means a jurisdiction that offers business and financial services to non-citizens and non-residents usually in the context of financial secrecy laws and practices. When referring to a financial institution, refers to a financial institution that primarily offers its services to persons domiciled outside the jurisdiction of the country in which the financial institution is organized.

Tax Haven

While there is no universally accepted definition of the term “Tax Haven,” the OECD, IMF and GAO generally use it to refer to a country that provides a no-tax or low-tax environment for foreign persons, lacks financial transparency for financial accounts, maintains laws preventing effective exchange of information for tax purposes and lacks any requirement that local activities be substantial.

Financial Secrecy

Refers to the confidentiality afforded to financial transactions either by enactment of law or by other means. Financial secrecy can be a part of an agreement between the institution and the client. Law can impose it with either criminal or civil sanctions. Financial secrecy can be operationally given by the financial institution whereby the institutional practices call for only top management to know who owns the account or no bank official knows who owns the account, such as a numbered account. It can also be obtained by the interposition of an attorney, nominee, or entity between the bank and its client.

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Beneficial Owner	Refers to the true owner of an entity, asset, or transaction as opposed to any stated ownership provided in documents or oral representations. The beneficial owner is the one that receives or has the right to receive proceeds or other advantages as a result of the ownership. It is common practice in offshore financial secrecy jurisdictions to interpose entities, individuals, or both as stated owners. The beneficial or true owner is contractually acknowledged in side agreements, statements or by other devices.
Controlled Foreign Corporation (CFC)	Any corporation organized outside the United States that is more than 50% owned by U.S. shareholders. A U.S. shareholder is any U.S. person that owns 10% or more of the foreign corporation. Rules regarding the taxation of income received by a CFC are complex and involve a determination of whether "Subpart F" income is present. If it is, then to the extent of the earnings and profits of the corporation, that income is taxable each year to the 10% or more U.S. shareholders. In addition to other filing requirements related to CFC's, form 5471 information returns are required to be filed annually.
International Business Company (IBC)	An International Business Company or IBC refers to a special type of corporation organized in an offshore secrecy jurisdiction that is afforded certain tax advantages and protection as to disclosure of its beneficial owner. Generally, IBCs are not allowed to conduct business in the jurisdiction where they are organized and cannot engage in business activity with its citizens or residents. Often, an IBC is used as a vehicle to hide beneficial ownership interest in bank accounts and assets.
Personal Investment Company (PIC)	A PIC is a term used in the banking industry to refer to a corporation or other entity formed to hold the investment assets of a bank client. When formed offshore, PICs are generally IBCs and so the terms are analogous.

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Trust	A form of ownership in which legal title is separated from beneficial ownership. The person creating the trust (the grantor or settlor) transfers legal ownership of property (the corpus) to a person or entity (the trustee). The trustee manages the property in accordance with the trust instrument or deed for the benefit of the beneficiaries identified in the trust instrument.
Foundation	An entity with no owners that is nominally controlled by Board of Directors. Property is transferred into the foundation to be used for a special purpose. Dependent upon the jurisdiction, the purpose of the foundation may be restricted to public or charitable purposes or used for personal purposes such as preserving family wealth.
Nominee	A nominee is an individual or entity that acts on behalf of a beneficial owner. Most often the nominee pretends to be the owner of an entity, asset, or transaction to provide a veil of secrecy as to the beneficial owner's involvement. Many offshore entities provide nominee services whereby they will provide a nominee to act as owner of your arrangement but generally will not act unless instructed to by the beneficial owner.
Private Banking	Private banking refers to a higher level of financial service afforded to wealthy clients. Private banking services may be provided by exclusive banks or by a department of a commercial bank that functions as a bank within a bank, maintaining its own separate books and records, and subject to separate operating procedures. Private banking activities are conducted through relationship managers and marketing officers who have access to a team of specialists around the world that provide personal money management, financial advice, and investment services to their high net worth clients. Private bankers are in a unique position of having knowledge and understanding of their client's personal and business backgrounds, sources of wealth, and uses of private banking accounts.

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Desk Files

A term used to describe “offline” files maintained by a Private Banker or Relationship Manager that contain identity and background information about their private banking clients. These files are sometimes called by other names and are sometimes claimed to be the personal files of the Private Banker or Relationship Manager.

Know Your Customer (KYC)

The due diligence principle that underlies effective compliance programs for anti-money laundering and combating the financing of terrorists. At the core of KYC is that financial institutions should know, verify and document the identity of the beneficial owner of financial accounts, and know the source of funds in those accounts. KYC due diligence rules exist in all financial secrecy jurisdictions.

Correspondent Bank Account

A bank account established at a domestic bank by a foreign financial institution used to receive deposits from, make payments on behalf of, or handle other financial transactions on behalf of the foreign financial institution. Correspondent bank accounts enable banks to conduct business and provide services for their customers in jurisdictions where they have no physical presence. Offshore banks use these accounts to receive and distribute funds outside their home location.

Payable Through Account

A domestic checking account provided to foreign banks that otherwise would not have the ability to offer their customers access to the U.S. banking system. The checking account is “sublet” to the bank’s customers that allows them to use checks in the United States. While the checks clear in the United States, all records are maintained outside the United States.

Offshore Merchant Account

A business bank account at an acquiring bank located outside the United States that is used by a domestic merchant as the account into which proceeds attributable to debit card and credit card transactions will be deposited. Offshore merchant accounts are often used by ecommerce businesses and high-risk businesses and can be used to keep transactions “off the books.”

Summary

1. U.S. persons are taxed on their worldwide income while non-resident alien individuals and foreign corporations are taxed only on certain types of income from U.S. sources and income effectively connected with the conduct of a trade or business in the United States.
2. Offshore service providers seek to exploit this general rule by creating offshore structures to make it appear as if a non-resident person or entity owns offshore assets and income when, in fact, they are owned and controlled by a U.S. person.
3. Offshore issues often come down to a determination of substance versus form. Aided by a cadre of professionals, facilitators and enablers, taxpayers will devise offshore schemes that in form create the appearance of legitimacy, while in substance are nothing more than shams.
4. The Offshore Financial Industry is made up of three distinct groups:
    a. Offshore Financial Centers that provide financial secrecy and other advantages to non-citizens domiciled outside the secrecy jurisdiction.
    b. Financial Institutions that provide the bank accounts, brokerage accounts, investment vehicles, insurance policies, etc. those are at the core of an abusive offshore tax scheme.
    c. Offshore Professionals that include lawyers, accountants, brokers, promoters, trust companies, bankers, private bankers, financial advisors, wealth managers and others, who promote, facilitate or enable the abusive offshore schemes.
5. Anonymity and discreet control are further enhanced through the use of nominee offshore entities such as foreign corporations, trusts and partnerships and are created as part of the overall structure to layer and obscure the beneficial ownership of the funds or assets while retaining covert control.
6. The four basic components of an offshore scheme are:
    a. devise an offshore plan,
    b. covertly transfer funds and assets offshore,
    c. control the funds and assets transferred offshore, and
    d. access or repatriate the funds when needed.

Exercises

Class Exercise 1

Which of the following are offshore entities?

a. Delaware Corporation
b. International Business Company
c. Domestic trust
d. Nevada LLC
e. Lichtenstein Foundation
f. Isle of Mann Trust

Answer:

b, e and f

Class Exercise 2

Which of the following are the four components of an offshore scheme?

a. Consult with an offshore financial advisor
b. Devise an overall offshore plan
c. Covertly transfer funds and assets offshore
d. Establish an offshore IBC or Trust
e. Open an offshore bank account
f. Control the funds and assets transferred offshore
g. Access or repatriate the offshore funds when needed

Answer:

b, c, f and g

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Class Exercise 3

Debora is examining the return of a privately owned software development firm and is reviewing deductions being claimed for consulting fees. The taxpayer provides copies of contracts and cancelled checks to support the claim. When she reviews the materials, Debora notices that the consulting firm is located in a financial secrecy jurisdiction and that the checks were cleared through the correspondent bank account of an offshore bank. Explain how offshore entities may have been used by the software development firm in the evasion of taxes.

Answer:

Debora may be using a false invoicing scheme to generate false deductions for her software development company by paying phony "consulting fees" to a sham offshore IBC she established to evade required taxes. The deposits may actually be going into an offshore account that she beneficially owns and controls.

Class Exercise 4

Randy is a successful plastic surgeon who wants to protect his family's wealth and assets from malpractice suits brought by patients. He considers the cost of the malpractice insurance needed to be too expensive so he meets with his attorneys and financial advisors. They decide to establish an asset protection trust and bank accounts in an offshore secrecy jurisdiction that can protect his family's wealth from lawsuits while ensuring that they still control and have access to the funds, and that the funds can be passed on to his heirs. This is an example of which component of an offshore scheme?

Answer:

a. Devise an overall offshore plan
b. Covertly transfer funds and assets offshore
c. Control the funds and assets transferred offshore
d. Access or repatriate the offshore funds when needed

Correct Answer:

a. Devise an overall offshore plan.

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Class Exercise 5

Define each of the following terms commonly used in the offshore financial industry:

a. International Business Company

Answer: An International Business Company is a special type of corporation organized in an offshore secrecy jurisdiction that is afforded certain tax advantages and protection as to disclosure of its beneficial owner.

b. Foreign Trust

Answer: A form of foreign ownership in which legal title is separated from beneficial ownership.

c. Beneficial Owner

Answer: The true owner of an entity, asset, or transaction as opposed to any stated ownership provided in documents or oral representations.

d. Correspondent Account

Answer: A bank account established at a domestic bank by a foreign financial institution used to receive deposits from, make payments on behalf of, or handle other financial transactions on behalf of the foreign financial institution.

e. Nominee

Answer: An individual or entity that acts on behalf of a beneficial owner. In offshore tax schemes, the nominee often pretends to be the owner of an entity, asset, or transaction to provide a veil of secrecy as to the beneficial owner’s involvement.

f. Private Banking

Answer: Refers to a higher level of financial service afforded by banks to wealthy clients through the use of relationship managers.

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Exhibit 9-1, *IMF list of 46 countries it considers Offshore Financial Centers*

Andorra	Anguilla
Antigua & Barbuda	Aruba
Bahamas	Bahrain
Barbados	Belize
Bermuda	British Virgin
Islands	
Cayman Islands	Cook Islands
Costa Rica	Cyprus
Dominica	Gibraltar
Grenada	Guernsey
Hong Kong	Ireland
Isle of Man	Jersey
Lebanon	Liechtenstein
Luxembourg	Macao
Malaysia (Labuan)	Malta
Marshall Islands	Mauritius
Monaco	Montserrat
Nauru	Niue
Netherlands Antilles	Palau
Panama	Samoa
Seychelles	Singapore
St. Kitts & Nevis	St. Lucia
St. Vincent and the Grenadines	Switzerland
Turks and Caicos Islands	Vanuatu

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International Technical Training

Chapter 22

Strategy for Conducting Offshore Examinations

Instructor Information

Lesson Data

Instructor information for this lesson includes:

Estimated Time	• 1 hour
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk
Participant References	• Handout PowerPoint Notes
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by instructor)

Overview

Introduction

Due to the nature of the records required for taxpayers with offshore activity, examiners must adopt an Offshore Strategy for these types of examinations. Many of the records are not located in the US and our ability to obtain these foreign based records can be limited, because normal summons procedures cannot be used to obtain records located in offshore jurisdictions. Examiners will have assistance provided by local counsel, Technical Advisors etc. This chapter will focus on the overall strategy that should be used by examiners faced with examinations of a taxpayer with offshore activity.

Objectives

At the end of this lesson, you will be able to:

- Identify potential offshore examination techniques.
- Determine offshore assets after interviewing the taxpayer.
- Determine when to request guidance from Counsel, Technical Advisors, etc.

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Contents

This lesson covers the following topics:

Approaches to Offshore Examinations

Instructor Notes

This course will examine approaches to Offshore Examinations such as:

- Follow the money
- Focus on what is NOT on the tax return
- Taxpayer interviews
- Sources of Information – Domestic & Foreign

Strategic Approach

In examining taxpayers who have financial activity in foreign jurisdictions, agents must carefully develop a plan for securing financial records prior to making contact with the taxpayer. Consideration must be given to the location of the foreign jurisdiction. Certain jurisdictions have tax treaties with the US. Other jurisdictions have Tax Information Exchange Agreements (TIEA) or other similar vehicles that enable the IRS to obtain information. It may be advisable to contact a Tax Attaché or Revenue Service Representative (RSR) to determine if the various types of information that you require is available.

This lesson covers approaches to offshore examinations. Depending on the type of examination, a Technical Advisor or Counsel Attorney may be assigned to assist with your examination. Before contacting the taxpayer, it is imperative that you review and understand all the information provided in the case file, because you might be asked to contact a Technical Advisor or Counsel Attorney prior to initiating the examination. They may have already mapped out a plan or audit approach for your case. In any event do not contact your taxpayer until you have identified the location of the foreign activity, because this will assist you in determining your ability to obtain information from that foreign location and what assistance you many need to accomplish this task.

The key to offshore activity is to identify the Beneficial Owner of the account or activity. Taxpayers will never lose control of the offshore accounts or assets, so be cautious of the existence, ownership or use of offshore financial assets.

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Parallel v. Linear Approach

Examiners should pursue many leads and audit trails simultaneously rather than lining them up to do one at a time. For example, in a domestic examination, you issue an audit letter with an IDR. After the initial interview, you may issue another IDR and wait another 30 to 45 days for a response. If you get no response, you then issue a summons for domestic records. At this point, you may be 6 months into an audit with no results. As a result of the summons, you may find out the taxpayer has offshore accounts.

When you are dealing with a taxpayer who has offshore financial transactions, schedule the appointment and issue the IDR with the appointment letter as you would in any examination. The taxpayer should be provided with a reasonable turnaround time for information, and you should enforce those time frames. You may want to have a Formal Document Request (IDR) and an administrative summons to the taxpayer ready to serve upon the taxpayer at the initial meeting if the taxpayer doesn't produce the records at the first appointment. You should refer the case for summons enforcement immediately when it becomes apparent that the TP is uncooperative and is stalling in providing requested information. Don't wait a year or more to take any action on a case that has now become overage.

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Follow the Money

The audit trail is the most useful tool an examiner can have when performing a financial audit. It is important to document the movement of funds through the taxpayer's accounts when dealing with offshore financial activity that you carefully document the movement of funds thru the taxpayer's accounts. "'Follow the money "is not a new term for accountants. It is more important today with the global economy. In 1920, Charles Ponzi originated the first documented Ponzi scheme in Boston. Articles about his scheme centered on the "money tree."

We must identify the financial activity of the taxpayer. To do this, care must be taken when analyzing financial accounts. Sources of deposits and destinations of withdrawals provide important information needed to determine the existence of undisclosed financial accounts.

Wire transfers were once popular devices to move money between domestic and foreign accounts. However more sophisticated methods have replaced direct wire transfers. In recent years, taxpayers have used credit cards issued by offshore financial institutions as a means of repatriating money to the US. Taxpayers can divert income to an offshore account, obtain a credit card issued by the foreign institution and use the credit card to withdraw cash or make purchases in the U.S and pay the credit card balance with funds in the offshore account.

Many banks have private banking divisions. If you summons a domestic bank and do not request information regarding the private banking activity, you may not receive all the bank information on your taxpayer.

As with any audit, it is important to follow every lead but when it comes to the audit trail for cash, the best advice is to follow the money.

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Focus on what is NOT on the return

Taxpayers who want to conceal offshore accounts will obviously not report any offshore transactions on their return. That is usually the purpose of operating in countries with financial secrecy laws.

Examiners should focus their attention as to how assets were acquired and where distributions were settled and not necessarily on what income the taxpayer reported. You should audit the taxpayer, not just the tax return. The taxpayer’s standard of living, asset acquisition, unusual banking transactions such as unidentified wire transactions should be scrutinized. In cases were we have information that the taxpayer has offshore accounts, you will be provided with the same type of information that you get with a prime lead case. Usually the information came from an independent source, so your task is to pursue that lead in an attempt to uncover the taxpayer's total financial activity.

Agents have a tendency to take a look at offshore activity and decide it is not worth pursuing due to the difficulty in obtaining records located in offshore jurisdictions. If your focus is on the return, and not the entire financial picture of the taxpayer, you will miss what could be substantial unreported income. If you google the term "offshore banking" you will get more that 1.5 million results. Placing your money in a country with bank secrecy laws is a popular financial planning method for many taxpayers. It is also a popular tax avoidance or tax evasion method. The deposits into those types of account and the earnings on those accounts will not appear on the tax return. It is the examiner's responsibility to be aware of the possibility that the taxpayer under audit has taken advantage of these secrecy jurisdictions.

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Counsel Role in Offshore Examinations

Your local counsel attorney's office should be consulted in examinations that have offshore financial transactions. The expertise of your counsel attorney is critical to the conduct of your examination. As stated previously, you should be prepared at the first interview with the taxpayer to issue a summons if the taxpayer fails to provide you with the information that you requested in your initial IDR. Furthermore, you should be prepared to issue a Formal Document Request. IRC Section 982 prohibits the taxpayer from introducing foreign-based documentation in a civil trail, if it was requested using a Formal Document Request and not provided. Your counsel attorney will assist you with the preparation of a summons for the taxpayer and a Formal Document Request if necessary.

In the event that your case is closed with an unagreed report, counsel attorneys will help you prepare the notice of deficiency. Counsel will assist you to insure the adjustments in the notice of deficiency can be supported.

Counsel attorneys assigned to offshore cases can assist you in interviewing witnesses They can help you prepare interview questions if you are unfamiliar with the types of entities used in offshore structures. Counsel attorneys are also available to attend interviews you conduct in offshore cases.

Counsel publishes a list of attorneys to contact for the various offshore projects. This information should be contained in your case file or website depending on the project.

In summary, Counsel attorneys are a valuable resource.You should contact them, with your manager's approval, early in your examination.

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Taxpayer Interview

As in every IRS examination, the taxpayer interview provides valuable insight into the items reflected or not reflected on the tax return. In an examination of a taxpayer with offshore financial transactions, this interview is critical. As stated above, it may be wise to contact your local counsel attorney for help with interview questions. You may want to take another revenue agent with you for the interview just to be sure that you don't miss important responses to your questions. Sometimes a court reporter is used so we can capture everything that is stated by the taxpayer. All of this must be done with your manager's approval.

Usually taxpayers are represented by an attorney or accountant under a power of attorney. This should not prevent you from requesting a meeting with the taxpayer if the power of attorney cannot answer your questions. A popular device used by representatives is to tell you that you must put all of your questions in writing so they can get their clients’ response. A good interview has predetermined interview questions but an excellent interview requires "follow-up" questions. If you provide a list of questions to the representative, you will not get the opportunity to ask follow-up questions. Therefore, do not provide a list of questions to a representative in lieu of interviewing the taxpayer.

You control the interview. If the representative cannot answer your questions, you should ask to interview the taxpayer. If the representative refuses, you should issue a summons to the taxpayer to come into your office for an interview. You may summons the taxpayer for testimony, records or both so your summons must be properly prepared. Once again, counsel can assist you with the preparation of a taxpayer summons.

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Taxpayer Interviews, (continued)

As previously stated, you must control the interview process. If you allow the representative to control the process, your interview will be ineffective. You will only receive the information that the representative wants to provide. IRC 7602 provides you with the authority to examine, summons, and take testimony in the examination process. You must be reasonable with time frames for requesting information from a representative who has power of attorney but if the representative cannot respond to your requests, you should summons any witness including the taxpayer, who has information relevant to your investigation.

Taxpayer interviews will be covered in more detail in Chapter 3.

Instructor Notes

If time allows, please show the participants a few websites.

Sources of Information – Domestic

The following are examples of domestic sources of Information. Keep in mind that it is the taxpayer's responsibility to provide the information needed to complete your examination.

Consider a summons to the taxpayer if the taxpayer fail to provide records you required. Often the most important source of domestic information is the taxpayer's bank accounts. Domestic bank statements should be examined carefully.

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Source of Information – Domestic, (continued)

The following are examples of domestic sources of information:

- SBSE International Treasury Enforcement Communication System (TECS) coordinator. (This information can not be shared with the taxpayer).
    - Information on when a taxpayer enters or leaves the country
    - http://mysbse.web.irs.gov/Collection/international/tecs/default.aspx
- CBRS
    - Currency Banking and Retrieval System
    - FBAR information/cash transactions
- CFOL/IDRS
    - Corporate Files on Line
    - Individual Data Retrieval System
- yK1
    - Link for related entities
- OCI Database
    - Contains information on offshore credit card transactions
- Lead Development Center (Criminal Investigation)
    - Suspicious Activity Reports (SAR)
    - Reveal (similar to yK1 information)
- Halls of Records
    - Government records/deeds/property tax records
- Internet sites
    - Google, Yahoo, etc
    - Promoter/promotion websites
    - Archive Websites (Wayback Machine- archive.org)
    - 3 ways to print a website
- Print it
- Use Internet Explorer: “File...Save As...*.MHT”
- Use Adobe: “File…Create PDF…From Web Page”

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Source of Information – Domestic, (continued)

NOTE: Agents should be cautioned about potential inadvertent disclosure of taxpayer identifying information when using internet sites.

- Proprietary sites
  - Accurint
  - Lexis/Nexis
- IRS Resources
  - Over the Telephone Interpreter (OTI) Service
  - Specialist Referral System (SRS)
  - TEGE Financial Investigation Unit (FIU)
- Government Resources
  - Bureau of Labor Statistics
  - Congress (House/Senate home page)
  - SEC
  - US Tax Court
- FATCA
  - Congress recently passed the Foreign Account Tax Compliance Act (FATCA), which imposes stricter IRS filing requirements on taxpayers who have overseas assets of more than $50,000.
  - Under FATCA, U.S. taxpayers holding certain financial assets outside the United States must report them assets to the IRS by attaching a new form attached to their tax return. Penalties apply for failure to comply with this new reporting requirement. Reporting is required in taxable years beginning on or after January 1, 2011.
  - Chapter 4 will cover FATCA in more detail.

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Sources of Information – Foreign

Note: Under no circumstances should IRS employees directly seek information by telephoning, writing or visiting a foreign third party record keeper such as a bank, law firm, registered agent, trust management firm or similar entity; by serving a summons on a financial institution located outside the U S or by contacting foreign government officials.

The following foreign sources of Information will be explained in detail in Chapter 3.

- Public information obtained through the Tax Attaché or Revenue Service Representative
  - TAs, the RSR and their deputies/assistants are knowledgeable and experienced IRS employees
  - May be able to secure information located in a foreign country even without a tax treaty of TIEA
- Tax Treaty
  - The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States.
  - These reduced rates and exemptions vary among countries and specific items of income. Under a particular treaty residents or citizens of the United States may be taxed at a reduced rate, or are exempt from foreign taxes on certain items of income they receive from sources within foreign countries.
  - Tax treaties generally include an exchange of information clause or article that can be used to obtain information.
- Tax Information Exchange Agreement (TIEA)
  - Tax Information Exchange Agreements (TIEAs) facilitate the exchange of information with many countries even if the U.S. does not have a bilateral tax treaty in place.
  - They generally allow for mutual assistance for both civil and criminal investigations.

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Sources of Information – Foreign, Continued

- Mutual Legal Assistance Treaty (MLAT)
  - requests for assistance (e.g., providing tax returns and return information) under the various treaties on Mutual Legal Assistance in Criminal Matters.
- Exchange of Information (EOI)
  - help IRS field personnel obtain information from foreign countries
  - work with IRS field personnel to provide information to certain foreign countries and coordinate the Mutual Collection Assistance provisions of certain treaties.
- Joint International Tax Shelter Information Centre (JITSIC)
  - The Internal Revenue Service and the national tax agencies of the United Kingdom, Canada and Australia have created the Joint International Tax Shelter Information Centre (JITSIC) to identify develop and share information and expertise about abusive tax avoidance transactions.
  - In 2007, the Japanese National Tax Agency joined JITSIC and in 2010, the tax agencies of the Republic of Korea and China joined as members.
  - JITSIC provides assistance relating to abusive tax avoidance transactions, arrangements and schemes involving member countries – Australia, Canada, China, Japan, Republic of Korea, United Kingdom, and United States.
  - JITSIC also shares expertise and information to combat abusive tax schemes.

Foreign Sources of Information can present a problem for the examiner. That is why some taxpayers have chosen to conduct financial transactions in offshore jurisdictions. However there are methods to obtain information. The assistance of your counsel attorney or technical advisor during your examination will be help with these cases.

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Project Guidance Documents

Depending on the offshore project, guidance papers (aka white papers) are usually included in the case files sent to the field for examination. Some projects utilize SharePoint websites to provide information to agents assigned these types of cases. Project guidance can range from administrative information such as the Project Code or Tracking Code required for the case. Depending on the complexity of the project, guidance on technical issues such as Alternative Minimum Tax or PFICs is provided. This information is very important to the examination of your project case. Many times there are independent databases set up for the project that require your input as you conduct your examination.

Before you begin your examination, examiners should thoroughly read any guidance documentation included in their case file.

Role of the Technical Advisor

The complexity of some offshore projects requires the assistance of a Technical Advisor. These are the experts that you can contact to assist with your examination. Counsel Attorneys can provide you with the legal procedures and requirements for issues that you encounter. Technical Advisors will assist you with the technical issues in your case. Usually the Technical Advisor has international experience. Taxpayers involved in offshore activity will sometimes use layers of entities to hide their ownership interests. You may not be familiar with the reporting requirements of these offshore entities which could have a major impact on your case. You will see in a later lesson that you may not be limited to a 3 or even a 6 year statute of limitations on your case depending on the filing of certain offshore entity returns. Technical Advisors do not evaluate your work on the case but they are involved in the technical development of the case.

It is important to note that the Technical Advisor does not replace your manager in the final decision of your case. They will assist you with case decisions but the final decision on any case issue remains with you and your manager. Technical Advisors do not generally attend taxpayer or representative interviews because they don't want to create the impression that they have authority over your case. The technical advisors are your advisors not the taxpayer's. You should use their expertise often in the examination of offshore issues.

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Coordination with Other Functions

Offshore examinations can affect many areas of the IRS. You will find that coordination with other functions can facilitate the examination of your case. The use of Revenue Officers, Special Agents, Fraud Technical Advisors, Technical Services and even Centralized Case Processing (CCP) will provide better insight into an examination involving offshore activity.

Many times your Project Guidance paper will give you information affecting the processing of your case. That information is usually determined in close cooperation with Technical Services or CCP. In cases that you suspect fraudulent activity, you should contact your local Fraud Technical Advisor. Ultimately you might work with the Criminal Investigation Division on your case.

In addition to the traditional role of Appeals in examination cases, some abusive promotions/schemes will be coordinated at a National level within Appeals to facilitate consistent resolution.

Revenue Officers bring a unique set of skills to offshore cases. In situations where a taxpayer has outstanding liabilities, a revenue officer should be contacted immediately for assistance. Revenue Officers can issue a collection summons which has a much shorter appearance date than a regular administrative summons. A cadre of Revenue Officers is sometimes created for particular projects similar to local counsel attorney cadre. Check for the list of Revenue Officers in your case file.

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Global High Wealth Program

The Global High Wealth (GHW) Industry focuses compliance expertise on high wealth individuals and the enterprises they control. High wealth individuals frequently operate complex enterprises consisting of multiple, interrelated businesses and flow-through entities, and often have international components The complex interrelationships and ownership patterns within these enterprises often mimic those of large corporations and pose significant challenges to effective tax administration. High wealth enterprises may collectively file many different types of returns of different types (corporate, flow-through, individual, and tax-exempt, and international). The GHW Industry takes a unified look at the entire web of business entities controlled by a high wealth individual to better assess the risk such arrangements pose to tax compliance.

Summary

1. Examiners must carefully review all documents provided by taxpayers who have offshore investments and transactions.
2. Your approaches to offshore examinations requires you to be prepared if the taxpayer does not provide records. Use a parallel examination approach and follow the money through the accounts.
3. There are various sources of domestic and foreign information for you to rely upon in offshore examinations.
4. You should not hesitate to contact Counsel Attorneys, Technical Advisors, Tax Attaches, Revenue Officers, and other IRS employees to help with these examinations.

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Answers to Class Exercises

Exercise 1

What is the difference between a linear and parallel approach to an offshore examination?

Answer:

The linear approach is a step-by-step examination whereby the examiner performs one task at a time and investigates one area of the return at a time. Basically an examination where we schedule an appointment and wait for a response before we take our next action. In the parallel approach the examiner takes multiple steps simultaneously rather than waiting until one step is finished before moving to the next one. For example, rather than waiting for a taxpayer to respond (or not respond) to an administrative summons before taking steps to issue a Formal Document Request, an IDR for domestic records and an IDR for foreign-based records are issued simultaneously.

Exercise 2

Describe the role of the Technical Advisor in an offshore examination.

Answer:

Technical Advisors provide multiple roles in Offshore examinations which include assistance in:

- the development of technical issues,
- the audit plan,
- the taxpayer interview, and
- the preparation of the Information Document Request.

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International Technical Training

Chapter 23

Audit Techniques

Instructor Information

Lesson Data Instructor information for this lesson includes:

Estimated Time	• 4 hours
Space Required	• Classroom
Methods of Instruction	• Lecture, reading and exercises
Instructor Material	• Instructor Guide
Participant Materials	• Participant Guide • CCH Disk • IRWeb
Participant References	• PowerPoint Notes
Equipment and Supplies	• Computer projection system and screen • PowerPoint slides (Prepared by instructor) • Flipcharts and markers

Overview

Introduction

Audit Techniques for examinations of taxpayers with offshore financial activity require an understanding of the offshore structure. Many times the taxpayer has multiple entities that disguise the beneficial ownership of the foreign accounts or assets. It is important to understand the purpose for placing assets in offshore secrecy jurisdictions. Although it is not illegal to conduct financial activity in an offshore jurisdiction, transactions should be analyzed fully. There are legitimate reasons for doing business offshore such as financial privacy or increased return on investments. The challenges facing examiners is to identity the transactions and determine if there is a US tax consequence. This chapter will help in making that determination.

Objectives

At the end of this lesson, you will be able to:

- Identify domestic sources of information
- Identify foreign sources of information
- Understand procedures to obtain foreign information
- Recognize common offshore schemes
- Prepare the interview steps necessary in examinations involving offshore information.

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Contents

This lesson covers the following topics:

Authority

Before we begin to talk about audit techniques, we need to identify our authority to conduct the examination. The following code & IRM sections are pertinent to every examination.

- IRC §6001 Taxpayer shall maintain sufficient records
- IRC §6011 Requirements for a return
- IRC §7602 Examination of books & Witnesses (summons)
- IRM 4.10.4 Examination of Income

You should be aware of these sections as you go through any examination especially when you deal in situations with limited taxpayer cooperation.

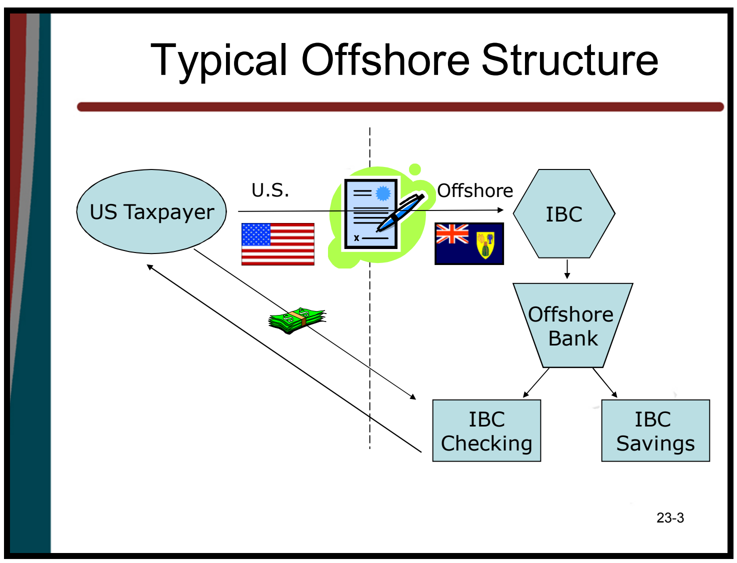
Offshore Structure

Instructor Notes

Please emphasize on the Offshore basic Structure.

Example 1

In Chapter 1 we discussed the typical offshore structure. It is important to look at this again so you have familiarity of the audit trail that you may need to follow. When you deal with offshore financial activity, it is similar to "peeling the onion". There are many layers of entities, bank accounts and financial transactions used to disguise the beneficial owner of an account or asset.



Information Gathering: Domestic Source Records

Overview

Taxpayers dealing in offshore financial transactions often leave a trail of domestic documents that can be helpful in examinations. Examiners should not overlook the domestic information that is available to them when conducting examinations of taxpayers with offshore financial activity.

Chapter 2 listed sources of domestic information that is readily available. A couple of important items to keep in mind when dealing with any taxpayer are your ability to summons for records. Even more important is the IRS ability to summons the taxpayer for the production of those records. It is not necessary for examiners to locate every possible summons source. Chapter 6 will provide detailed information regarding summonses.

For a taxpayer who is reluctant to produce the records requested, consider a summons issued directly to the taxpayer to produce the records. Of course your starting point is usually the domestic bank accounts of the taxpayer. They should provide you with some insight into the domestic and maybe the foreign activity being conducted.

Third Party Records

When dealing with taxpayers who have offshore financial transactions, you should consider other sources of information. Bank records are one such source but examiners should also consider requesting pertinent documents from the following:

- Records of Deeds to identify property transactions
- Brokers who may have account statements, correspondence, or other documents that reflect ownership or control of offshore assets or entities.
- Promoters who may have a prospectus, agreements, correspondence or other records that may identify control of offshore transactions.
- Any other third party in the US (attorneys, accountants, etc) who may be able to provide insight into the taxpayer's financial activity.

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Domestic Bank Records

As a general rule, examiners should always attempt to secure records through domestic avenues before attempting to obtain records through offshore sources. There are a several reasons for this:

- It takes more time to secure records from offshore sources, and
- Certain audit tools [(e.g. formal document requests, income tax treaties, and Tax Information Exchange Agreements (TIEAs)] should not be used if the records are available in the US.

You should be aware of the types of records available from domestic banks. In addition to bank statements, signature cards, account opening documents, bank correspondence, and investment directives should also be considered when examining taxpayers with offshore activity.

Loan records maintained by the bank are also a good source of information that could lead you to property owned or controlled by the taxpayer. You should follow-up on the banking information whether it leads you to search property records or any third party contacts that will give you the best view of the taxpayer's financial interests.

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Instructor Notes

Private Banking Departments are not known to the agents. Please emphasize in this area.

Private Banking Departments

When considering bank records it is important to remember that banks have different banking departments so there may be other accounts in addition to the regular account statements maintained by the bank. Some banks have private banking departments that maintain separate banking records. Private banking departments center on meeting the needs of the bank's largest depositors. Frequently these activities extend to the establishment and oversight of offshore operations. Records relating to these activities may be kept outside the normal financial records of the bank. If you summons a bank, be sure to also request records of the private banking department to be sure that you receive complete records of the taxpayer's financial activity.

Another important point when dealing with domestic banks is not to assume that the taxpayer's foreign entity bank accounts are offshore. Many foreign banks maintain a presence in the US. Also, a taxpayer may maintain bank accounts in the names of foreign entities to disguise control over the accounts. Nevertheless, the taxpayer may have signature or other authority over these bank accounts.

When preparing a summons or Information Document Request (IDR), it is important to request (1) all bank records over which the taxpayer has ownership interests, (2) signatory privileges, and (3) rights to make withdrawals, or for which the individual is shown as the trustee, co-signer, guardian, custodian or beneficiary.

Evidence of control can be found in the signature cards, account applications or correspondence between the bank and the taxpayer. In some cases, banks have been found to have letters on file, letters instructing them to honor checks bearing rubber stamp signatures of a trustee or corporate officer. Such a document may cause you to view photocopies of paid or deposited checks in an entirely different light.

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Instructor Notes

If possible, please show the class an example of a copy of a wire transfer and the language on it.

Wire Transfers

Offshore transactions can easily be conducted by wire transfers from domestic banks to offshore banks and vice versa.

You should be aware that banks maintain wire transfer logs of this activity. Also when requesting wire activity, examiners should request the "wire detail" that will show both the source and destination of the wire.

Beneficiary information for a wire transaction is crucial in the flow of money offshore. As a result of the summons requesting the "wire detail," we may find out the taxpayer has offshore accounts.

Correspondent Bank

Another source of banking information is the correspondent bank. A correspondent bank is a domestic bank used by a foreign bank to make payments or receive checks in the US on behalf of the foreign bank.

Example

A Cayman Island Bank may use X Bank to clear checks through the US. Checks written on offshore bank accounts need to clear through a correspondent bank that is a member of the federal reserve system.

Offshore banks must set up a correspondent relationship with a domestic bank. Sometimes these relationships last for a year and sometimes they only last for a few months. Checks written on offshore bank accounts will clear through a domestic bank (correspondent bank).

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Correspondent Bank (continued)

Although the correspondent bank may be a source of information, keep in mind that the customer of the correspondent bank is the offshore bank.

If you would like to review transactions, you will have to go through all the transactions of the foreign bank to locate checks or deposits relating to your taxpayer. Correspondent banks may be a source of information but you should consult your local counsel before you summon a domestic bank for its correspondent bank information.

Information Document Request (IDR)/ Summons

If a taxpayer transfers substantial funds offshore, common sense dictates that they would not have done so without retaining sufficient control over the funds.

Therefore, examining agents should issue the taxpayer an Information Document Request (IDR), informally requesting all relevant records. If the taxpayer has control over the records, he must produce them wherever they are physically located.

If the taxpayer does not produce the desired records, the examiner should consider issuing the taxpayer a summons requesting both testimony and documents. Taxpayer testimony should elicit the following:

- The structure of the offshore transactions
- The business purpose of the transactions
- The promoter or facilitator of the transactions
- The location of the desired records: and
- Who has access to the requested records

No summons should be issued by the IRS unless we are prepared to enforce it. Local counsel should be contacted before you issue the summons for assistance in the language. If the taxpayer fails to appear in response to the summons, local counsel will assist you in referring the case to the Department of Justice for enforcement.

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Information Document Request (IDR)/ Summons (continued)	All leads provided by the taxpayer should be followed-up on including, but not limited to third-party sources. Remember that you can only contact third parties present in the United States with knowledge of the transaction at issue. Once again, local counsel can assist you to prevent unnecessary disclosure of tax information.

Information Gathering: Foreign Based Records

Instructor Notes

Please go over with the class the International Website for:

1. Exchange of Information
2. TAs and RSRs
3. Treaty countries
4. TIEAs
5. JITSIC

Overview

If records cannot be secured through domestic sources, there are tools available to obtain certain foreign based records.

Foreign based information is any information located in a foreign country that may be needed for income tax purposes. Requests for foreign-based information are handled by LB&I Tax Attachés (TAs), Revenue Service Representatives (RSRs) and Headquarters Exchange of Information (EOI) groups in Washington, DC.

Under no circumstances should IRS employees directly seek information by telephoning, writing or visiting a foreign third party record keeper such as a bank, law firm, registered agent, trust management firm or similar entity; by serving a summons on a financial institution located outside the United States; or by contacting foreign government officials without first clearing the contact with the appropriate TA/RSR or Exchange of Information Group Manager in Washington, DC.

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Overview (continued)

The following information is required to request assistance from a Tax Attaché, RSR or EOI group:

1. Requests should be forwarded to the Tax Attaché, Revenue Service Representative, or Exchange of Information Team Manager having jurisdiction for that country, for assignment and control.
2. The request must be in writing. Oral requests and email inquiries must be followed up in writing.
3. The request must be complete and comprehensive, detailing all necessary and relevant facts so that the Foreign Competent Authority is aware of the initiator's needs and timeframes.

Tax Attaches

The IRS has Tax Attaches who may be helpful in obtaining records located in foreign secrecy jurisdictions. Tax Attaches are IRS employees stationed in various parts of the world They can provide the type of information and records maintained by a specific foreign jurisdiction.

An examiner can request the assistance of a tax attaché to search property records or determine who incorporated a foreign corporation. Keep in mind that the Tax Attaché cannot usually obtain bank statements from foreign banks. Bank secrecy laws are designed to prevent release of this type of information to anyone other than the owner of the account(s).

Tax Attachés are stationed in certain countries. Information can be found at the following website:

http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/TaxAttacheContactInformation.asp

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Tax Attaches (continued)

IRC §7602(c) generally provides that the IRS may not contact third-parties with respect to the assessment or collection of a taxpayer's tax liabilities without first issuing a third-party contact letter. The following principles apply with respect to contacts involving the Tax Attaches.

- A contact by the examining agents with a Tax Attaché is not, in itself, a third-party contact for which a third-party contact letter is required. This is because Tax Attaches are IRS employees.
- A contact by a Tax Attaché with a foreign governmental entity is not a third-party contact for which a third-party contact letter is required.
- A contact by a Tax Attaché with a third-party other than a foreign governmental entity may be a third-party contact for which a third-party contact letter is needed. In situations like this, you should issue the third-party contact letter. Local counsel should be consulted if questions arise.

Tax Attaché post locations can be found at:

http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/TaxAttachePostJurisdictions.asp

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Tax Treaty

The US has negotiated bilateral income tax treaties with many foreign countries.

Each treaty is unique, although the subjects covered by the treaties are similar. Often, a tax treaty will specify the procedures necessary to obtain information and documents from that country. Where a tax treaty is specific regarding procedures for requesting foreign documents and information, the treaty provisions must be followed.

The US competent authority has exclusive authority for making and receiving exchange of information and administrative assistance requests under all tax treaties.

Information and documents secured pursuant to a tax treaty are confidential and may not be divulged except as specified in the treaty or by written consent of the foreign government.

A master list of tax treaty countries can be found at:

http://lmsb.irs.gov/international/dir_treaty/treaty/downloads/TreatySpread%2003-26-10.doc

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Tax Information Exchange Agreements (TIEAs)

The US also has negotiated agreements with numerous foreign countries governing the exchange of tax information. These are Tax Information Exchange Agreements.

The purpose of each TIEA is to assist the respective countries in accurately assessing and collecting taxes, to prevent fiscal fraud and evasion, and to develop improved information sources for tax matters. TIEAs are separate from tax treaties, but do not supplant an existing treaty.

The primary difference between TIEAs and tax treaties is the TIEAs are designed principally for the exchange of information between countries, and tax treaties contain numerous provisions in addition to those pertaining to information exchange.

Information secured pursuant to a TIEA is confidential and may not generally be divulged to third-parties.

A listing of treaties and TIEAS currently in effect can be found at:

http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/eoi/tiea.asp.

An examining agent should exhaust domestic avenue for securing the desired information prior to initiating a treaty or TIEA request.

Examiners should contact the Tax Attaché who has jurisdiction for the county to determine the information required to make a treaty or TIEA request.

A listing of jurisdiction information can be found at:

http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/TaxAttachePostJurisdictions.asp

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Types of Information Obtained under Income Tax Treaties and TIEAs

Specific Requests – A specific request occurs when the IRS asks a treaty partner for particular information that is relevant to a pending tax matter. This is the most commonly used device. See IRM 4.60.1.2.

Spontaneous Exchange – Exchange without a specific request with the information obtained during an examination, collection activity, or otherwise, which suggests or establishes noncompliance with the tax laws of its treaty or TIEA partner. Information may pertain not only to U.S. citizens, residents, and domestic corporations, but also to nonresident aliens, foreign corporations, or other persons who may have a tax liability under U.S. law.

Automatic or Routine Exchanges – This is a mass exchange of passive income (dividends, interest, rents, and royalties). The taxpayers are generally not under audit.

Simultaneous Examinations – This is the exchange of information that relates to a specific taxpayer that is being examined by two or more countries simultaneously. Each country designates a representative to direct and coordinate the examination.
See IRM 4.60.1.3.

Types of Information that can be obtained from Treaty Partners

1. Tax return information such as filing status, income/expenses;
2. Bank, brokerage (stock/securities) and other financial records;
3. Interview of witnesses;
4. Business records;
5. Public records;
6. Accountant and attorney records;
7. Insurance company records.

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Limitations on the Use of Information Received Under a Treaty or TIEA

Every treaty and TIEA contains a nondisclosure provision in the exchange of information article. The nondisclosure provision applies to information received to:

- Treat the information as secret in the same manner as information obtained under the domestic laws of that country; and
- To disclose the information only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection or administration, of the enforcement, prosecution or the determination of appeals in relation to, the taxes covered by the treaty.

Exchange of Information

Exchange of Information (EOI) is a variety of programs in LB&I under the Director, Competent Authority & International, with offices in Washington D.C.; Plantation, Florida; London, United Kingdom; Paris, France; Frankfurt, Germany; and Beijing, China.

Today there is a growing need to exchange information because of globalization of economies and increased possibilities of tax avoidance and evasion.

The Exchange of Information:

- Helps IRS personnel to obtain information from foreign countries (US Initiated)
- Works with IRS personnel to provide information to foreign countries (Foreign Initiated)
- Coordinate Mutual Collection Assistance provision of certain treaties (Canada, France, Sweden, Denmark, and the Netherlands).

Only the U.S. Competent Authority can exchange information without violating U.S. Disclosure Statutes and Treaty/TIEA Secrecy provisions.

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Exchange of Information (continued)

More information is available on the EOI website:

http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/eoi/index.asp

Mutual Legal Assistance Treaty (MLAT)

An MLAT creates a contractual obligation between the treaty partners to render to each other assistance in criminal matters in accordance with the terms of the treaty. It is designed to facilitate the exchange of information and evidence for use in criminal investigations and prosecutions.

The U.S. may initiate a request for assistance under an MLAT when a criminal matter is at the trial stage, or is under investigation by:

- A prosecutor;
- A grand jury;
- An agency with criminal law enforcement responsibilities, such as the IRS's Criminal Investigation Division; or
- An agency with regulatory responsibilities, such as the Securities and Exchange Commission.

Types of Assistance Available:

- Serving documents in the requested state;
- Locating or identifying persons or items in the requested state;
- Taking testimony or statements from persons in the requested state;
- Providing documents, records, and articles of evidence located in the requested state;
- Executing requests for searches and seizures in the requested state.

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Joint International Tax Shelter Information Centre (JITSIC)

JITSIC was created in 2004 by the Internal Revenue Service and the tax agencies of the United Kingdom, Canada, and Australia.

In 2007, the National Tax Agency of Japan joined JITSIC.

In 2010 the National Tax Service of the Republic of Korea and the State Administration of Taxation of the People's Republic of China joined as members.

Representatives from the member countries work together in Washington, D.C. and London to supplement the ongoing work of member tax administrations in identifying and curbing abusive tax avoidance transactions, arrangements and schemes and to enhance activities against cross-border transactions involving tax compliance risks.

The objective of JITSIC is to enhance each Revenue Authority's enforcement efforts through coordinated and real time exchange of tax information consistent with the provisions of our bilateral income tax conventions.

U.S. JITSIC Technical Advisors and Delegates are designated to act as "competent or taxation authority" under the income tax treaties that the United States has with both member and observer countries listed below for exchanges of information, in accordance with the terms and conditions of the applicable treaty or treaties, related to the Joint International Tax Shelter Information Centre.

More information can be found at their website:

http://lmsb.irs.gov/international/JITSIC/index.asp

Formal Document Request & Summons

Formal Document Request

IRC § 982 governs the use of Formal Document Requests (FDR). Generally, a taxpayer served with a Formal Document Request must produce the foreign records requested therein, or they will not be able to use the records in a subsequent civil litigation.

If a taxpayer fails to respond to an informal request for foreign-based records, the IRS may formally request the records under IRC §982. An examining agent must informally request the foreign-based records prior to serving a Formal Document Request. This is normally accomplished though the use of an Information Document Request (IDR).

If the taxpayer does not produce all the foreign records requested in the IDR, the examining agent may issue a Formal Document Request.

A Formal Document Request may only be used with respect to records that are located outside the US. If the records are located within the US, the examining agent must secure the records via a summons, not a Formal Document Request. If the taxpayer fails to produce the records within 90 days of the formal request, without reasonable cause, any court later handling the taxpayer's case will prohibit the taxpayer (but not the Government) from using in evidence any records not produced. The Code explicitly states that foreign secrecy laws are not reasonable cause for failing to produce foreign-based records.

The process begins with serving the taxpayer with an IDR for foreign-based records. Local counsel should be contacted prior to issuance of a Formal Document Request but basically if the taxpayer fails to comply with the initial IDR for foreign records, the foreign IDR becomes an attachment to a cover letter and together they constitute the § 982 Formal Document Request.

Before issuing an FDR, there are two requirements:

- The normal request procedures must have been used, and
- The taxpayer must have failed to produce the documents.

Continued on next page

Formal Document Request (continued)

The FDR:

- Can be "**any request**",
- Can be mailed by registered or certified mail, and
- Will be sent to the taxpayer at the **last known address**.
- Applies to books and records located "outside the United States".

More detailed information regarding an FDR is discussed in chapter 6.

Formal Document Request vs. Summons

A common question is whether an examining agent should utilize a Formal Document Request or a summons to secure documents. In making this decision, the examiner should consider the following:

- A Formal Document Request may only be served on the taxpayer. A summons may be served on either the taxpayer or a third party. Thus a summons should be utilized if the desired records are in the possession or control of a third-party witness.
- A Formal Document Request may only be used to secure records that are located outside the US. A summons may be used to secure relevant records, located in the U.S. If the examining agent is unsure about the whereabouts of the records, they may serve both a Formal Document Request and a summons.

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John Doe Summons

Due to the success of the John Doe summons to identify taxpayers who are likely to be violating the U.S. tax laws, but whose identities are unknown the Service is using this process more frequently as a tool for identifying taxpayers involved in abusive offshore activities. John Doe Summonses are used when the identities of the taxpayers in question are not known.

An examining agent, with court approval, may serve a John Doe summons to ascertain the identities of the taxpayer and also secure other information (including documents) relevant to the taxpayers' tax liabilities.

An examining agent may not serve a John Doe summons without first securing the approval of a US district court. Examining agents should enlist the assistance of local counsel to prepare a referral package to the Department of Justice, which will file a petition for leave to serve a John Doe summons.

The requirements for a John Doe Summons listed in IRC § 7609(c) are as follows:

- The summons must relate to the investigation of a particular person or ascertainable group or class of persons;
- There must be a reasonable basis for believing that such person or group of person may fail or may have failed to comply with the federal tax laws; and
- The information sought must not be readily available from other sources.

Internet Research

Instructor Notes

If possible, please show the students other useful websites.

The internet is a powerful tool in any examination but even more important when working with a taxpayer with offshore transactions. Just doing a GOOGLE search of any offshore bank utilized by the taxpayer can give you important information about the bank. Just a few notes about internet sites are important. Once you identify a website owned by your taxpayer, there are two useful sites to explore. One is www.archive.org (formally Wayback Machine). This site will show changes made to the website during the years in existence. It may prove interesting to see how your taxpayer's webpage has changed over the past few years. Another good source of internet site is www.internic.net (formally Who is) which will provide you with the owner or originator of the site.

Other uses of the Internet could include:

- Database searches for court cases: Legal actions
- Public records searches
- CBRS search
- News items online and offline
- Internet searches for information and business related web pages

Note: Examiners must be cautious not to disclose taxpayer information when using internet sites such as GOOGLE.

Diverted Income

Once you begin the audit, it is important to be able to recognize schemes used in offshore financial transactions. Remember that the taxpayer's ultimate goals are control and diversion of the offshore funds or assets.

The following schemes are examples where the beneficial owner of the offshore account or assets has been concealed.

The first example looks very easy to operate but it has been proven successful for quite a few taxpayers. Taxpayers merely report some of their income in the US and divert some of their income to an offshore bank account in the name of an International Business Company (IBC).

In situations were the taxpayer receives payment by check cash, they merely endorse the checks in the name of their IBC and just simply mail the checks offshore to the bank.

The IBC (owned by the TP) has an offshore bank account and the diverted receipts are deposited into the offshore accounts. The taxpayer can use a credit card linked to the offshore bank to repatriate the diverted funds to pay for various personal purposes.

If you think about an internet company, they could easily divert some of their sales to an offshore bank account. The appeal of these schemes is that the customers have no idea that their payments for goods or services have been transferred offshore.

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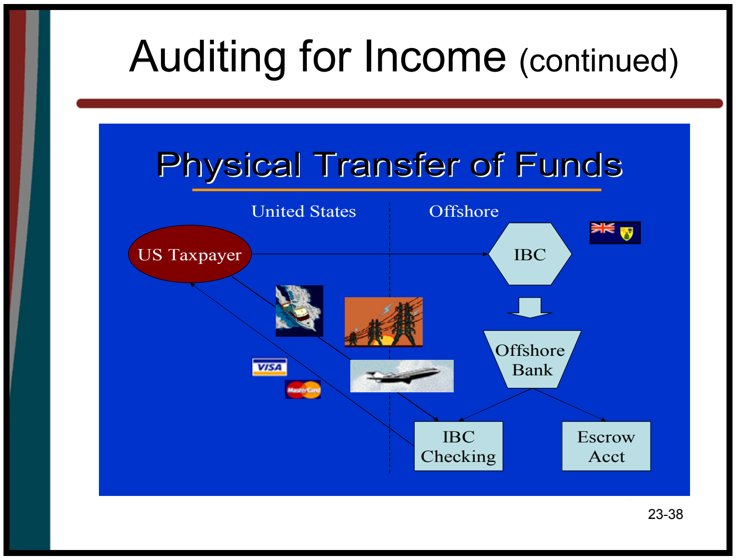
Example 2

This process is illustrated in the examples below:



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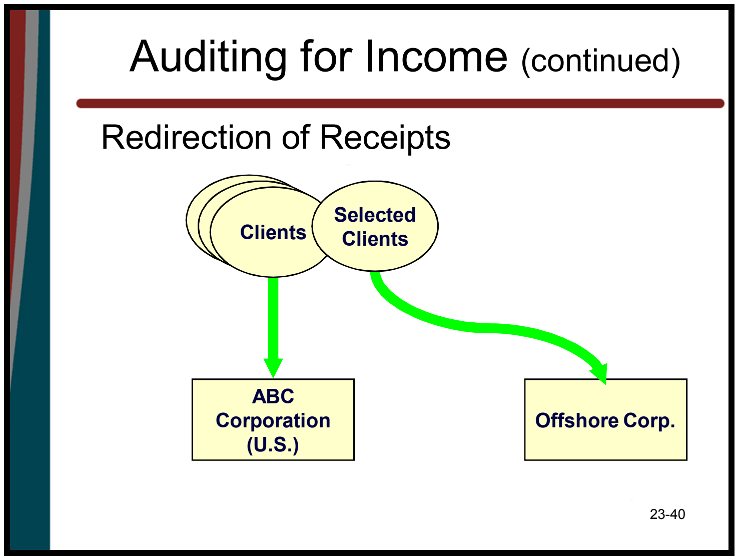
Example 3



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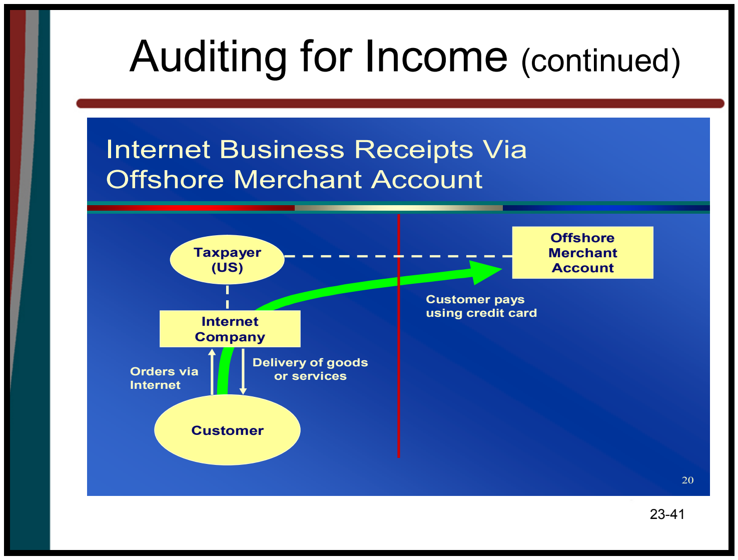
Example 4



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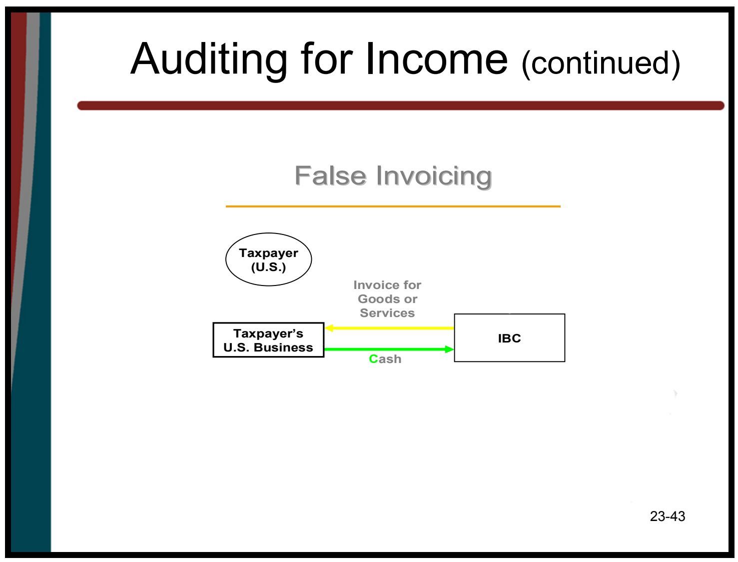
False Invoicing

Example 5

False Invoicing once again involves the use of an offshore IBC owned by the taxpayer. The IBC can merely bill the company for non-existent goods or services. The US company will pay for these services and claim a deduction for moving the funds offshore to the taxpayer's offshore account in the name of the IBC.

Example 5 illustrates this concept



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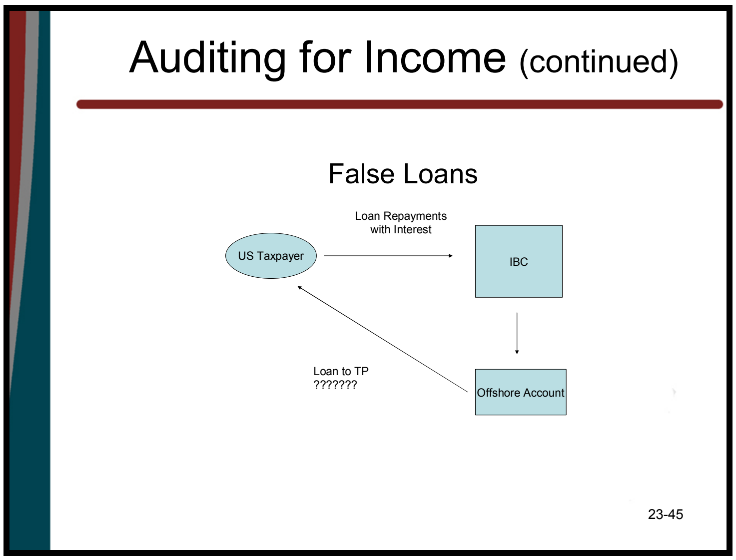
False Loans

Example 6

False Loans is another twist with the use of an offshore IBC. The offshore bank "loans" the taxpayer what appears to be a normal loan. The US taxpayer repays this loan with interest thereby moving money offshore in what appears to be a loan repayment arrangement and the US taxpayer claims a deduction for the loan interest.



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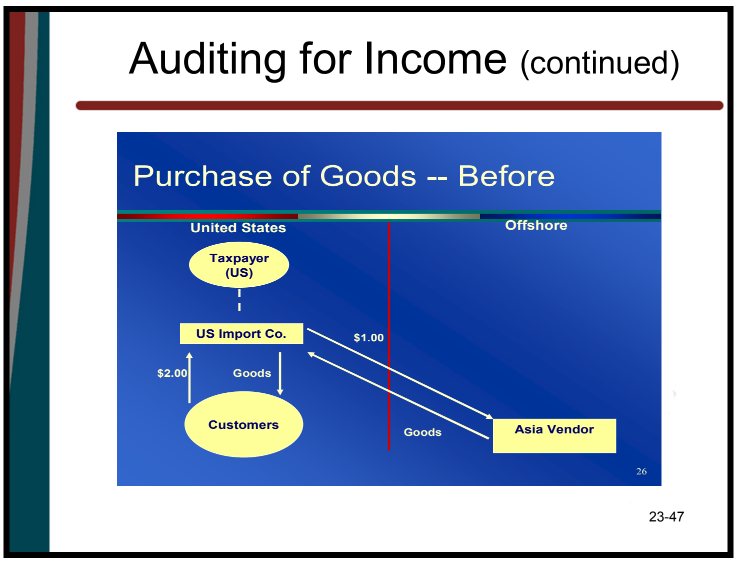
Re-Invoicing

Example 7

Another twist to false invoicing is the concept of re-invoicing. In this scenario there are goods purchased by the taxpayer's IBC. The IBC then sells the goods for a higher price to the US Corporation. Because there are actual goods involved in the transaction, it adds credibility to this scheme. However the offshore IBC (owned by the taxpayer) has diverted a portion of the purchase price and the US corporation claims an inflated, cost of goods sold deduction for the diversion of the income.



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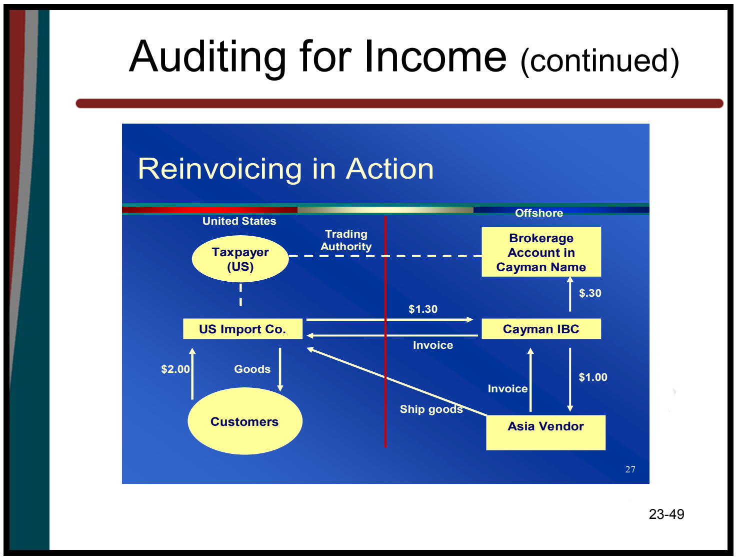
Re-Invoicing
(continued)

Example 8



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Transfer Pricing

U.S. persons who own or control foreign entities with which they conduct business may be manipulating the U.S. tax effects by not using a true “arms length” standard for their transactions.

When a taxpayer fails to conduct transactions with “related parties” on an “arms length” standard, we often refer to these issues as “Transfer Pricing” issues.

In determining the true taxable income of a taxpayer, the “arm’s length standard” is applied in every case. A transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if unrelated parties had engaged in the same transaction under the same circumstances. Treas. Reg. §1.482-1(b)(1).

The Service has the authority under IRC §482 to reallocate income, deductions, credits or allowances among related parties to more accurately reflect taxable income. These "transfer pricing " adjustments can originate in a wide variety of situations such as:

- Sales and exchanges
- Debt transactions, and
- Performance of services.

The purpose of IRC §482 is to ensure that taxable income (and, consequently, tax liability) does not depend on the taxpayer’s relationship to other parties. It requires that the taxable income from related party transactions be the same as taxable income from unrelated party transactions, based on the same circumstances.

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Transfer Pricing (continued)

Example

Assume Mr. Elms (a U.S. citizen) owns 100% of Corporation A (U.S. corporation), and 100% of Corporation B (Canadian Corporation). Mr. Elms controls the sales made between Corp. A and Corp. B, and consequently goods are sold from A to B for $100 per item. If Corp. A sold such goods to unrelated parties in Canada; they could be sold for $200 per item. Taxable income reported by Corp. A from the sales to Corp. B would not be the same as its taxable income from the sale to unrelated buyers.

Transfer pricing adjustments are usually made when a taxpayer has shifted income from a U.S. entity to a related entity abroad or has shifted deductions from a foreign entity to a related U.S. entity.

In either case, the taxpayer has increased or decreased prices, interest rates, or other terms of the transaction above or below market level to increase the profit one entity makes and decrease the profit the other makes.

Transactions between the U.S. taxpayer, U.S. entities the taxpayer controls and related foreign entities should be scrutinized to be sure the pricing terms are arm's length.

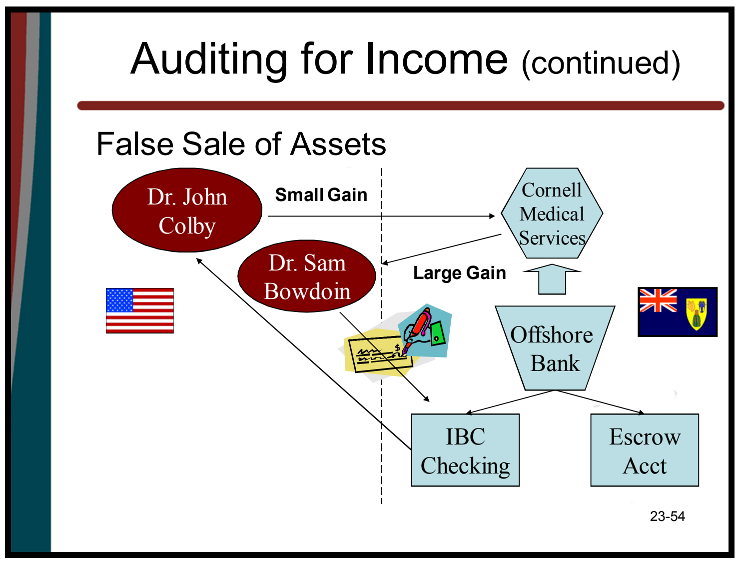
Referral to an international examiner or economist may be necessary. In some cases it may be necessary to develop a transfer pricing issue as an alternative issue or whipsaw position to complement another position the Service is taking with respect to a particular offshore transaction.

Continued on next page

Sale of Appreciated Assets with Diverted Proceeds

Example 9

This scheme involves the sale of a business or other appreciated asset to an offshore IBC that is owned by the taxpayer. The sale results in a small gain in order to give the transaction credibility. Then the IBC sells the business to the real buyer and the gain is diverted to the IBC. Therefore, the taxpayer can sell his business (or any asset) to another buyer but disguise the real sale and divert the real gain.



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Merchant Accounts

U.S. businesses establish merchant accounts in offshore locations to divert business proceeds from debit card and credit card sales so as to improperly avoid or evade taxation.

Card association rules require that “cross-border” merchant accounts be located where the merchant is incorporated and primarily conducts business.

U.S. merchants can circumvent this requirement by establishing IBC’s in offshore financial centers and then use them to open merchant accounts at offshore banks.

IBC then receive the credit card payments and the sales are immediately diverted to an offshore account. The acceptance of credit card sales can be manipulated directly to the TPs offshore account.

Captive Insurance

A captive insurance company is a company that is wholly-owned by another company whose main purpose is to insure the risks of the parent and related companies.

The courts have defined a “captive insurance company” as a corporation organized for the purpose of insuring the liabilities of its owner. At one extreme is the case where the insured is both the sole shareholder and only customer of the captive.

However, the captive insurance industry has grown significantly over the past two decades as has case law and IRS’s position. As a result we now have captive insurance companies that insure more than just the owner's liabilities. The industry has been very innovative with this concept and has resulted in many new types of captive companies being formed.

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Captive Insurance (continued)

Some examples of these new arrangements are:

- Premiums paid to an unrelated fronting company and reinsured with a subsidiary.
- Premiums paid by parent to captive subsidiary, which also accepts third party business.
- Jointly owned captive who also insure their risks with the captive.
- Jointly owned captive who also insure their risks with separate accounts for each member/owner.
- Brother – sister captive insurance arrangements.

Most of these captive insurance companies are foreign corporations incorporated in jurisdictions that have favorable laws which impose no tax or a minimum tax on premium or reinvestment income generated by the insurance of the world-wide risks of the parent and related companies.

For many businesses, a major expense item is their mandated or defensive insurance costs which for some enterprises, can run into the hundreds of thousands of dollars. Not only is this level of expense frustrating for many business owners in low-risk but high premium industries, so is the conventional insurance market's failure to meet their financial needs, especially in terms of price, service, cover and capacity for certain types of risk.

As a result, U.S. persons may create offshore "Captive Insurance" companies to meet these needs. However, these "Captive Insurance" companies can also be used as vehicles to shift income offshore, where it may earn additional income without incurring tax.

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Captive Insurance (continued)

Although the Internal Revenue Code does not define the term "insurance," the United States Supreme Court has held that to constitute "insurance," a transaction must involve "risk shifting" (from the insured to the insurer) and "risk distribution" (by the insurer).[1] It should be noted that self-insurance and "Captive Insurance are not the same. In this regard, amounts set aside by a taxpayer as a "self-insurance" reserve for anticipated losses are not insurance expenses because risk is not shifted from the taxpayer; therefore, such amounts are not deductible until the taxpayer actually pays or accrues the anticipated loss.[2]

The IRS position with respect to captive insurance used to be that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one "economic family" for purposes of the risk-shifting analysis. Under the economic family theory the transactions were not insurance to the extent that risk was retained by the captive insurance subsidiary. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible. However, no court fully accepted the economic family theory set forth in *Rev. Rul. 77-316*.

The Service will no longer use the economic family theory enunciated in Rev. Rul. 77-316. Rev. Rul. 2001-31 eliminated the economic family theory, as a basis for proposing an adjustment. Instead, the Service will rely upon existing case law to determine whether a captive insurance transaction qualifies as insurance for tax purposes.

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[1] Helvering v. Le Gierse, 312 U.S. 531, 539, 61 S. Ct. 646, 85 L. Ed. 996 (1941)
[2] United States v. General Dynamics Corp., 481 U.S. 239, 243-244, 107 S. Ct. 1732, 95 L. Ed. 2d 226 (1987).

Captive Insurance (continued)

Thus, the Service will continue to deny insurance treatment to parent subsidiary transactions where there is an absence of substantial unrelated risks. In contrast, where the transaction involves a brother sister transaction, or where the captive insures substantial unrelated risks, the Service will look at the facts and circumstances underlying the transaction to determine whether it qualifies as insurance for tax purposes. Such factors include, but are not limited to: the presence of guarantees and indemnification agreements; the captive's level of capitalization; an arm's length determination of premiums; the transfer of insurance risk under the terms of the policy; professional and independent management of the captive; and the presence of excessive loans from the captive to related parties.

In some cases the determination may be that the captive insurance company was a sham corporation, used merely by the U.S. person to shift income offshore through an expense deduction claimed on the U.S. person or related entity's U.S. income tax return. In these situations you may see an apparent circular flow of funds, such as insurance premiums being returned to the taxpayer or a related entity in the form of loans. In determining if the captive insurance company is a sham corporation some of the items to consider are the same as those mentioned above in determining whether the insurance payment qualifies as a deductible expense for tax purposes. For instance, did the U.S. person prop-up the captive by guaranteeing its performance; was the captive thinly capitalized, and was the captive loosely regulated by the locale in which the captive was incorporated (i.e., Bermuda) Other factors considered in determining whether a captive insurance transaction is a sham include: whether the parties that insured with the captive truly faced hazards; whether premiums charged by the captive were based on commercial rates; whether the validity of claims was established before payments were made on them; and whether the captive's business operations and assets were kept separate from its parent's.[3]

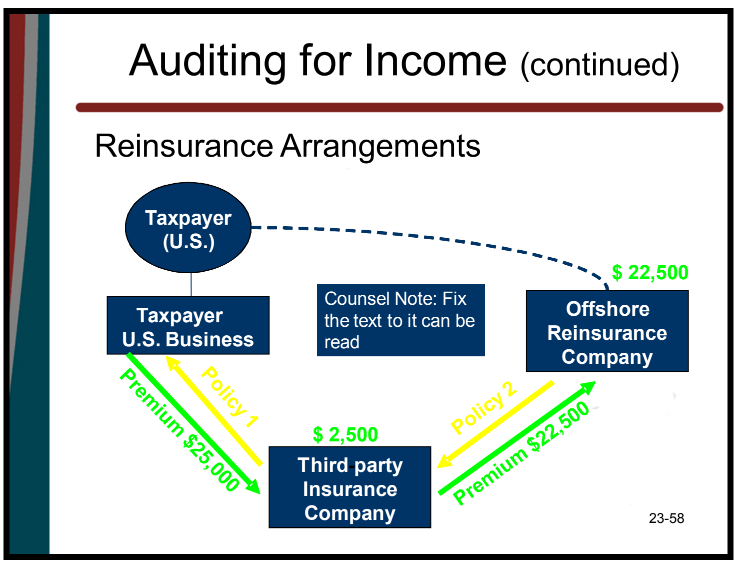
Continued on next page

[3] Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

Captive Insurance (continued)

As depicted in the below diagram, legitimate domestic insurance companies may become involved in schemes to deduct overstated amounts as "insurance premiums". The taxpayer's U.S. business pays premiums to an unrelated domestic insurance company that reinsures the policy with an offshore company operated by or for the taxpayer, with no real transfer of risk, no reserves, etc. The premiums are paid to an unrelated domestic insurance company subject to an agreement that it will immediately transfer 90% of the risk under reinsurance agreements to the offshore company operated by or for the taxpayer. Since the majority of the risk is transferred to the offshore re-insurance company owned or controlled by the taxpayer the determination would be that at least 90% of the risk was not shifted from the taxpayer. Additionally, the taxpayer used this arrangement to repatriate 90% of those premiums in a nontaxable manner in the form of loans (demonstrating a circular flow of funds).

Example 10



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Private Annuities

Private annuities are annuity arrangements that are unsecured contracts entered into between the annuitant and someone who is not in the business of issuing annuity contracts.

Private annuities have been used as a way to transfer funds offshore and defer tax on the fund's earnings as well as a way to transfer appreciated assets offshore and defer tax on the gain from the sale of those assets.

We have seen numerous cases in which taxpayers exchanged substantially appreciated property for a private annuity contract written by an International Business Company (IBC) domiciled in a foreign financial secrecy jurisdiction, acquired or created for this purpose. The start of the annuity may be deferred, in some cases, as long as 20 years from the transfer of property.

Typically, the corporation issuing the annuity contract is indirectly controlled for the benefit of the taxpayer. The IBC may sell the property for cash, perhaps to a buyer with whom the sale was pre-negotiated by the original owner of the property (the taxpayer), or receive income generated by the property, such as foreign source license fees or royalties, without any U.S. tax consequences. The foreign corporation (IBC) may then fund back-to-back loans or other means by which the taxpayer gains almost immediate use of the funds, in purportedly tax free form.

In the past, relying on *Rev. Rul. 69-74*, which held that any gain is recognized pro rata over the actuarial life of an annuity and on *General Counsel Memorandum (GCM) 37371, December 22, 1977*, holding that an unsecured private annuity has no ascertainable fair market value, taxpayers were advised that the transfer need not be reported and any gain on the transfer was not taxed until annuity payments were received.

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Private Annuities (continued)

Due to the proliferation of private annuities with controversial, claimed deferred or avoided tax treatment over the past few years, the IRS proposed an end to private annuity deferred tax treatment by issuing proposed regulations, generally applicable to transactions completed after October 18, 2006.[4]

The proposed regulations would apply the same rule to exchanges for both private annuities and commercial annuities, such that gain realized on the exchange of appreciated property for a private annuity generally would no longer be deferred.

Taxpayers exchanging property for a private annuity will now have to calculate the tax on the fair market value of the annuity and recognize gains immediately at the time of the exchange.

The Proposed Regulations obsolete Revenue Ruling 69-74 because it had been relied upon inappropriately in a number of transactions designed to avoid U.S. income tax. This ruling was originally based in part on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes. This assumption is no longer correct. The ruling has its roots in authorities that applied the "open transaction doctrine," which has been eroded in recent years.

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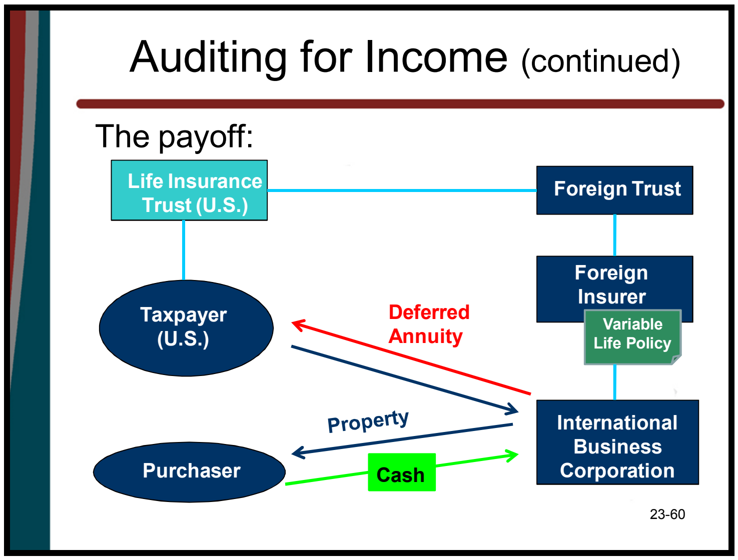
[4] PROP-REG, TAX-REGS, §1.72-6. Investment in the contract
Amendments to Reg. §1.72-6, providing guidance on the taxation of the exchange of property for an annuity contract, are proposed (published in the Federal Register on October 18, 2006) (REG-141901-05)

Example 11



In the abusive tax avoidance transaction depicted above the taxpayer has transferred the property to a foreign entity (IBC) which he controls or is controlled on his behalf merely to get the property offshore where he can defer any immediate gain and the property can be sold without any U.S. tax consequences.

Even though the proposed Treas. Reg. § 1.72-6(e) would require that gain be recognized immediately upon the exchange of the property for the private annuity there are also numerous statutory provisions and common law doctrines, such as substance over form and the step transaction doctrine, which may be relied upon to combat abusive tax situations.

As a result, the annuity transaction and related sales of assets could be disregarded under the above theories, as an alternative position.

Auditing for Income: Indicators of Offshore Activity

Instructor Notes

Please emphasize this important section.

Payment to Foreign Entities

Taxpayers involved in offshore abusive tax transactions will generally use a number of methods to transfer funds/assets offshore to conceal their continued ownership and control over those assets and the income which continues to be generated by those funds/assets.

There are many techniques to move funds offshore. It is only limited by the imagination of the taxpayer and the offshore service provider. Identifying the methods used to transfer funds/assets offshore will be an indicator that the taxpayer is engaged in offshore activity.

One of the techniques/methods used to transfer money offshore is by the taxpayer claiming a deduction on his U.S. Income Tax Return or the U.S. Income Tax Return of any related entity he owns for payments to a foreign entity. Taxpayers may have invoices created by an offshore entity for nonexistent goods or services. Creating false invoices is a service readily available, for a small fee, from offshore corporate formation and management companies.

Taxpayers will then pay these invoices and claim a deduction on a U.S. Income Tax Return under the guise that it is a legitimate transaction and a deductible expense.

This accomplishes two benefits for the U.S. taxpayer. It allows the taxpayer to move the funds offshore to a foreign entity and foreign financial account he directly or indirectly controls and it also allows him to reduce his taxable income in the United States, because the payment is claimed as a deduction on a U.S. Income Tax Return thereby reducing taxable income.

As a result, payments to foreign entities for lease payments (for property and employee services (i.e., employee leasing) loan payments, including mortgages, insurance, etc. need to be scrutinized further and are indicators that the taxpayer is engaged in offshore activity.

Continued on next page

Payment to Foreign Entities (continued)

Taxpayers have used offshore employee leasing (OEL) arrangements combined with deferred compensation arrangements to move funds and assets offshore and avoid U.S. income taxes on the individual taxpayer's current income and U.S. self-employment tax at the same time.

Offshore Employees Leasing

Taxpayers who participate in Offshore Employee Leasing Arrangements typically cause funds to be transmitted through a leasing arrangement to a Foreign Leasing Company.

Under the arrangement, an individual taxpayer purports to enter into an employee leasing contract with a Foreign Leasing Company which does not conduct business in the United States. The Foreign Leasing Company assigns most of the rights and obligations under the contract to a Domestic Leasing Company. The Domestic Leasing Company then contracts with an entity which utilizes the taxpayer's services (Service Recipient Company).

The Service Recipient Company is usually owned and/or controlled by the individual taxpayer. Through this arrangement, funds are transmitted from the Service Recipient Company to the Domestic Leasing Company. A portion of the funds are paid to the taxpayer as wages, and the balance of the funds are sent offshore to the Foreign Leasing Company. The offshore funds are accumulated in a fund balance held for the taxpayer's benefit.

Similar arrangements with foreign entities that the taxpayer owns or controls can be set up for leasing equipment or real property. Taxpayers may even contract for leasing nonexistent equipment from a corporation controlled by the taxpayer which is located in a financial secrecy jurisdiction. The taxpayer will typically claim a deduction for the lease payments which he really made to himself.

Again this accomplishes two benefits for the U.S. taxpayer: (1) it enables him to move funds offshore and (2) reduces U.S. taxable income by generating an improper deduction on a U.S. income tax return.

Continued on next page

Payment to Foreign Entities (continued)

Eventually, the taxpayer will want to access the money that has been transferred offshore. People who were not willing to pay tax on it when they moved it offshore or pay tax on its earnings while it sat offshore are not likely to be willing to pay tax on it when they bring it back.

As a result quite often the money will be repatriated disguised as a legitimate transaction, such as loan, including a mortgage secured by their personal residence. As with other payments to foreign entities, this will accomplish a number of benefits for the taxpayer: (1) enables the taxpayer to repatriate funds previously transferred offshore (2) enables the taxpayer to move additional funds offshore in the form of interest and/or principal payments (3) reduces U.S. taxable income in the form of an interest expense (i.e., mortgage interest) or as interest paid on a business loan.

The loan may be from a foreign entity not generally known to be in the business of making loans or it may be from a foreign financial institution. In the situation in which the lender is a foreign financial institution the taxpayer may have structured the loan as follows:

A U.S. individual or company using an offshore entity, which the U.S. person owns or controls but does not disclose that ownership or control to the IRS, opens a bank account with a major international bank. For example, an individual purchases a USD $100,000 certificate of deposit at 9 percent with a major U.K. bank's branch in Panama.

The U.K. bank in turn arranges a mortgage loan from its branch in a major financial center like New York for the full amount of the certificate of deposit. Continuing with the above example, the individual receives a USD $100,000 mortgage at 10 percent from the U.K. bank's New York office.

The individual makes regular interest only payments on the mortgage loan. The interest is normally tax deductible on Schedule A. As a result the taxpayer has really borrowed his own money on deposit with the bank's Panama branch and is paying interest (or at least the equivalent of the 9% of the 10% interest) to himself.

Continued on next page

Payment to Foreign Entities (continued)

As described above the taxpayer can access offshore funds by "borrowing" such funds for the purpose of stripping equity from the taxpayer's real property. A personal residence that has a lot of equity can be "stripped down" to the homestead level and thus discourage litigation and encourage earlier and cheaper settlements for any legitimate creditors seeking to collect from the taxpayer.

Payments to Nevada and/or Wyoming Entities

Offshore planning has historically utilized foreign jurisdictions that offered low or no tax, bank secrecy, ease of company and trust formation and favorable asset protection laws.

Nevertheless, there are states within the United States that have actually played a critical role in many offshore structures. Nevada and Wyoming entities are widely used by abusive promoters, non-filers and other non-compliant taxpayers, such as those taxpayers involved in offshore activity in order to hide assets and funds offshore, because of these state's favorable laws, an established industry of resident agents and internet incorporation services. Individuals who establish entities in these states for these abusive purposes are generally residents of other states or countries.

Favorable laws in these states include those allowing the use of nominee officers, bearer shares and those which fail to require disclosure of beneficial ownership. Nominee services allow unrelated individuals to be listed as officers of a corporation thereby hiding the true owner. Bearer shares actually confer ownership of an entity upon the individual in physical possession of the shares. It doesn't hurt either that Nevada and Wyoming does not have a state income tax.

A typical scheme involves a resident agent filing for formation of a company with the Nevada Secretary of State and listing nominee individuals as the company's officers.

The company is formed in a matter of hours and includes a TIN from the IRS, a bank account in the corporation's name, and a resident agent for all corporation business.

Continued on next page

Payments to Nevada and/or Wyoming Entities (continued)

The true owner, who is never disclosed, can now operate a legal corporation under a veil of secrecy. As time goes on, the owner may allow the corporate filing to lapse, thereby avoiding any further state reporting requirements, and ending official state record keeping.

Any IRS inquiry will only reveal the resident agent and original nominee board of directors both of whom could be the promoter or a straw man used by the promoter. The owner can use the corporation and bank account to hide income and facilitate numerous abusive activities.

A Nevada or Wyoming corporation may be used as an intermediary when payments flow between the taxpayer and the offshore structure. The transactions are structured to make it appear that the Nevada or Wyoming corporation is providing some sort of service for a fee.

The owner may also have another corporation, seemingly compliant, that writes checks for “business purposes” to the Nevada entity and deducts the payments as consulting fees, etc. The money may then flow offshore as a payment by the Nevada or Wyoming corporation to an offshore entity of the taxpayer for some supposed business purpose and therefore deducted by the Nevada or Wyoming corporation. Or instead the funds once in the hands of the Nevada or Wyoming corporation may be deposited into a Nevada Warehouse banking operation.

Nevada and Wyoming corporations may also be used when a taxpayer wishes to repatriate funds that were already transferred offshore. The taxpayer might bring funds back into the U.S. to acquire real property or businesses. If the Nevada or Wyoming corporation was formed with bearer shares, the shares might be held by another corporation located offshore.

Ownership can then only be discovered by determining the owner of the offshore corporation – which could be another corporation. When purchasing U.S. real property or businesses with "offshore" funds, neither the taxpayer nor his offshore entities will own the U.S. assets directly. Instead, a Nevada or Wyoming corporation will be created that is owned by the offshore entities.

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Loans and/or Gifts from Foreign Entities

As previously mentioned, once a taxpayer has accomplished transferring funds/assets offshore without revealing that he continues to own and control those funds/assets, at some point in time he will usually want to repatriate those funds/assets back to the United States for his personal use.

However, since he typically transferred the funds/assets offshore using a method that avoided or evaded tax, he will typically try to repatriate the funds/assets in such a way that will not result in tax. People who were not willing to pay tax on it when they moved it offshore or on its earnings while it sat offshore are not likely to be willing to pay tax on it when they bring it back.

One of the simplest techniques employed by taxpayers to access offshore funds is to disguise it as a loan or gift from a foreign relative or entity. This method requires taxpayers to either receive a check or wire transfer from the bank account of a foreign entity they own or control or to route the intended offshore funds, from the bank accounts of a foreign entity they own or control, first to the foreign relative as an intermediary. The funds are then wire transferred to them from the foreign relative and characterized as a loan or gift.

IRC §6039F requires the reporting of foreign gifts. The threshold reporting amount is more than $100,000 for gifts from foreign individuals and $10,000 for gifts from foreign partnerships or corporations, which is adjusted for inflation.

The foreign relative is used because of the perceived difficulty of the IRS to compel foreigners to provide information to the IRS.

The examination should be directed to whether the foreign relative has the ability to loan or gift the funds to the taxpayer. A focus should also be made as to whether the taxpayer has an ongoing business in the foreign country that hasn't been disclosed.

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Large or Unusual Wire Transfers or Transfers to Foreign Accounts

As noted earlier in this chapter, wire transfers are a popular method of moving money offshore. Examiners should scrutinize wire transactions reported on bank statements to fully understand the purpose and beneficiary of the wire.

Large or Unusual Expense Items/Losses (e.g. Consulting Fees, Management Fees, Feasibility Studies, etc.)

Large expense or expenses that result in a loss to a taxpayer should be examined closely, especially if they involve fees for consulting or some type of study. A common scheme is to pay expenses to the taxpayer's offshore IBC that is disguised as a management or consulting fee. This can be difficult to uncover but there should be some justification for these types of expenses especially if they did not exist in the prior years.

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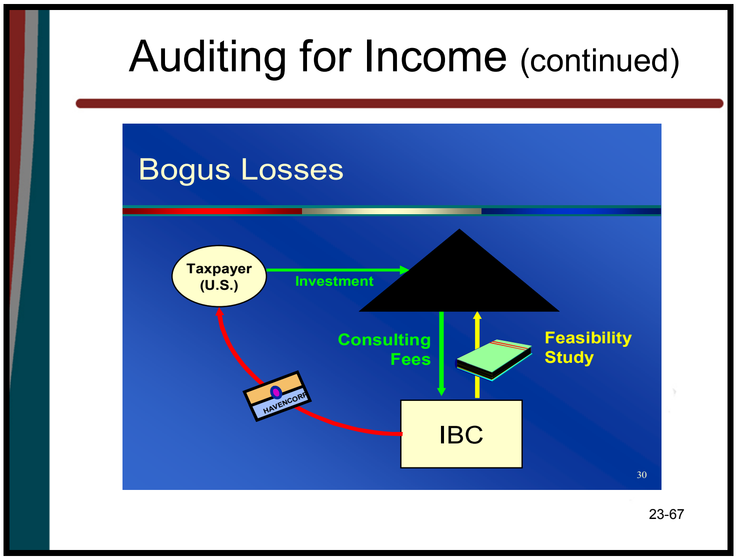
Example 12



There are no cookbook instructions of how to examine a TP with offshore transactions. However you cannot just accept transactions at face value as you can see in the examples above. You must be aware of the possibility that the taxpayer has structured an empire that includes layers of offshore entities as well as layers of bank accounts. The examiner must determine the degree or extent of examination steps required in these type of examinations. Keep in mind that the structuring was done purposely to hide beneficial ownership and detection of these transactions is not always easy. Many of the examples listed above included offshore trusts or foundations that further hid the real transaction. The examples were stripped down for presentation purposes so it would be easy to see how the funds were diverted and repatriated as if they were normal business transactions.

Interview Techniques

Instructor Notes

This is the prelude to the Mock Interview Exercise.

As in every IRS examination, the taxpayer interview provides valuable insight into the items reflected or not reflected on the tax return. In an examination of a taxpayer with offshore financial transactions, this interview is critical. As stated above, it may be wise to contact your local counsel attorney for help with interview questions. You may want to take another revenue agent with you for the interview just to be sure that you don't miss important responses to your questions. Sometimes a court reporter is used so we can capture everything that is stated by the taxpayer. All of this must be done with your manager's approval. There are also notice requirements to the taxpayer when you wish to record an interview.

Many taxpayers are represented by an attorney or accountant with a power of attorney. But this should not prevent you from requesting a meeting with the taxpayer if the representative cannot answer your questions. A popular device used by representatives is to tell you that you must put all of your questions in writing so they can get their client's response. A good interview has predetermined interview questions but an excellent interview requires "follow-up" questions. If you provide a list of questions to the representative, you will not get the opportunity to ask follow-up questions.

You are in control of this interview process. If the representative cannot answer your questions, then you should ask to meet with the taxpayer. If the representative or taxpayer refuses, issue a summons to the taxpayer to come into your office for an interview. Once again, counsel can assist you with the preparation of a taxpayer summons. You may want to summons the taxpayer to provide testimony, records or both. Your summons must be properly prepared and served.

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Many taxpayers with offshore accounts hire expert attorneys or CPAs. Their job is to protect their client and they will do everything to achieve that protection. You must determine if a taxpayer interview is necessary and when you cannot rely on the representative to respond to your questions.

Remember that you must control the interview process. If you allow the representative to control the process, you will not receive the information necessary for your examination. You will only receive the information that the representative wants to provide.

IRC 7602 authorizes you to examine, summons, and take testimony in the examination process. You must be reasonable with time frames for requesting information from a representative who has power of attorney but if the representative cannot respond to your requests, a summons should be issued to the taxpayer for testimony and records.

The Interview is the most important part of your offshore case examination. The use of proper interview techniques is a crucial component of your examination strategy on an offshore case. Much of the paper documentation related to your case will probably “reside” offshore in a financial secrecy jurisdiction. Useful testimony often resides in this country. The trick is to uncover key pieces of oral testimony and to fit the information together like a puzzle.

The use of interviews in an offshore case is an art form. In many instances, there will be numerous witnesses to interview. Understanding the taxpayer’s affairs will help identify the witnesses. Each witness will provide a piece of the puzzle and/or provide needed information to conduct a subsequent interview.

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You should take the following steps in preparing who and when to interview:

- Identify interview goals
- Identify persons to interview, understand what each person may know
- Be strategic in the order that you conduct interviews
- Be prepared for each interview
- Clearly define your goals
  - A major goal will be to find a witness that will tell you that your taxpayer owns/controls a particular offshore entity or financial account.
  - A minor goal may be to find a witness that will tell you that your taxpayer **controlled** a particular transaction.
  - Identify persons who have reasons to know information relating to part or all of your goals
  - You may have to piece together information received from many sources to complete a picture

Consider the following list of potential people to interview:

Customers	Family Members
Suppliers	Prior Examiners
Competitors	Drivers
Business associates	Pilots
Accountants	Association
Bankers	UPS , shippers, etc
Brokers	Government agencies
Financial advisors	(customs, etc)
Current employees	Realtors
Former employees	

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The sequence of who you interview is important. Often witnesses provide information that you can effectively use in subsequent interviews. You may decide to interview persons who are farthest away from the taxpayer's control or influence. These individuals have less motivation to hide facts that could be important to you case.

You should try to determine how each witness fits into your case. The point here is it may not be wise to interview the taxpayer first when doing an examination involving taxpayers with offshore transaction. There will be claims by witnesses and the taxpayer that important documents are located in offshore secrecy jurisdictions and difficult for the taxpayer to obtain.

As stated earlier in this chapter, you should have already done thorough research of all available information such as Internet research for web pages and public records search.

You should make copies of key documents for presentation during an interview. If you ask a witness to identify key document signed by a witness, ask if the signature is that of the witness.

Before doing an interview, you must do your homework. You should know what you expect the witness to provide whether you are talking to a prior accountant or the taxpayer. Interviews should not be conducted like a cross-examination. You should try to maintain a comfortable environment and engage in small talk on topics that a witness shows interest, even if it has nothing to do with the interview. Tactfully control the conversation so you are able to obtain the information that you are looking for.

The most difficult part of interviewing is allowing witnesses to talk. Do not finish a sentence for witnesses during an interview regardless of how long delays may be. This is difficult for an examiner but you don't have to fill the air with constant conversation. Let witnesses gather their thoughts and respond to the questions. Silence can be used as a motivator for witnesses to provide more information.

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It is important to take notes during the interview and revisit key points as necessary. When a taxpayer or witness makes a statement that you believe to be the key you should repeat the statement and ask the taxpayer or witness to confirm their understanding.

Confront discrepancies in a way that you do not appear to be accusing the taxpayer or witness of lying. Try asking for clarification rather than accusing the witness of lying.

Sometimes it may be necessary to conduct the interviews with another agent from your office. This allows one agent to ask questions while the other agent takes notes or ask follow-up questions.

If the witness or taxpayer provides documents, allow yourself enough time to understand the documents and ask questions to ensure your understanding of the documents.

You must be patient when conducting an interview. This is a reason to have a follow-up interview to give you an opportunity to prepare appropriate follow-up questions.

In summary, it is the agent's responsibility to interview the taxpayer and every witness connected with the case that can shed light on a particular transactions and the possibility of unreported income. An effective interview provides sufficient facts to evaluate the total financial situation of a taxpayer, including mode of living, investments, unusual expenditures, as well as gifts, loans or inheritances, and other nontaxable amounts received.

Summary

1. This chapter only outlines the domestic and foreign sources of information available for an IRS examination. Also various schemes of diverted income were presented to illustrate the degree of structuring that a taxpayer will do to hide beneficial ownership. Keep in mind that control of offshore assets is a key concern for taxpayers. Documents presented to substantiate transactions are not always what they appear to be.
2. Examiners must look at a transaction and determine if it makes sense. Not all offshore schemes are easy to detect and sometimes difficult to prove. The examination should be viewed as a challenge to the ability of the examiner to uncover the real transaction. The best advice is to follow the money trail. The goal in offshore transactions is to repatriate that diverted income back to this country so examiners will need to be aware of the complicated and sophisticated schemes employed in offshore transactions.
3. Taxpayer's with offshore financial transactions require examiners to carefully review documents provided.
4. You approach to examinations of this type require you to be prepared for the lack of records. This requires parallel examination techniques as well as the ability to follow the money through the accounts.
5. There are various sources of information both domestic and foreign that you can rely upon in offshore examinations.
6. You should not hesitate to contact Counsel Attorneys, Technical Advisors, Tax Attaches, etc. to help with these examinations.

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Mock Interview

Scenario for Mock Interview

Taxpayer – Eddie Dodger is under exam for the years 2008 thru 2010.

Dodger owns 100% of Crazy Eddie's "We Got Ya Computer Supplies Right Here" in Brooklyn, NY. Crazy Eddie's sells computer supplies & accessories to retail stores. Dodger is the president of the company and operates as a C corporation.

Crazy Eddie's purchases all products that they sell from Shamara LTD, an Asian manufacturer located in Japan.

Prior to 2008, Shamara billed Crazy Eddie's "We Got Ya Computer Supplies Right Here" for the cost of all computer parts and accessories purchased. CGS increased significantly beginning in 2008. In examining CGS during these periods it was discovered Crazy Eddie was paying invoices for computer parts and accessories to Regdod LTD, which is a Cayman Island corporation.

Also beginning in 2008, Crazy Eddie's "We Got Ya Computer Supplies Right Here" paid a very large Management Consulting Fee that was deducted on the corporate tax return to a company Aramahs, LTD, which is a Cayman Island corporation.

The case has been in process for some time and the t/p has refused to be interviewed so……………..

A summons to appear for an interview was issued to the t/p and other 3rd parties have been contacted/ summonsed.

Players

CRAZY EDDIE DODGER: with his NY accent & charm

D. VADER, ESQ. & POA: of the firm Slime, Sleaze & Vader LLP.
Vader is former IRS Associate Counsel &
A Known promoter of offshore
Arrangements/transactions

I.R. SHARP: Revenue Agent

L.L. EAGLE: Senior Area Counsel assigned

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Situation

After L.L Eagle referred the summons of Dodger to the Department of Justice, Vader and Dodger agree to appear and produce documents – a court reporter is present for the interview.

The Script

Pleasantries exchanged…………

TP - How ya dooooin!

RA – Will the court reporter swear in the witness

RA (FOR CR) - Mr. Dodger do you solemnly swear that the testimony you are about to give will be the truth……………………..

POA – Hold on a minute here – nobody said anything about putting my client under oath – I object to this…………………..

AC – (AC nicely explains to the POA) Under IRC 7602 and IRM section 25.5.4.2 that the RA has the right to require the t/p to provide testimony under oath - "Mr. Vader, this interview is being conducted pursuant to the summons issued to Mr. Dodger and RA Sharp has the authority to under 7602 and the IRM to put MR. Dodger under oath.

Some time after the conclusion of the interview the service will provide a copy of the transcript to your client if you wish. Mr. Dodger will then be given the opportunity to provide additional oral or written testimony if he wishes to make any changes or corrections to his testimony.

Are you still objecting to putting your client under oath?

Are you directing your client not to be sworn in?

RA - I have a copy of the IRM section if you would like one.

POA - I am not happy about this but it appears that you are correct so let's proceed,

RA – finishes with the oath

Continued on next page

The Script (continued)

TP – well………..I guess…………..OK…………….I Do

RA - I want to remind everyone to please wait until others are finished talking as the court reporter cannot record two people talking at the same time and Mr. Vader if you need to discuss something with your Client you can request we go off the record.

RA – Would everyone please state your name and title for the record

ALL – Everyone does

RA – MR Dodger are you currently taking any medication or do you have any physical or mental impairment that would affect you ability to truthfully answer questions today?

TP – Well they do call me "Crazy Eddie"- Just kidding! I took a bunch of aspirin – this whole thing gives me a friggin headache!!! I mean why are bustin my chops!

RA – Anything that would affect your ability to truthfully answer my questions today?

TP – FORGETABOUTIT!

RA - I need for you to answer yes or no.

TP - UH - OK - No just the aspirin and I don't have any disabilities, mental or otherwise.

RA – Mr. Dodger would you describe your educational and job experience background beginning with after high school?

T/P – Well I went to Columbia University of course – got a degree in business & accounting – then I worked a summer with an accounting firm and – forgetaboutit - I just hated it – what a bunch of losers!!!!!!!! (You know what I mean?) So I started my computer accessories business.

Continued on next page

The Script (continued)

RA – That would be Crazy Eddie's "We Got Ya Computer Supplies Right Here". Correct?

TP – Yeah that's it

RA – And what year did you acquire Crazy Eddie's?

TP – Oh – back in 2000 – but it started out as a small computer repair business. I started making a lot of business contacts in the computer industry and one thing led to another and I saw how lucrative the computer supply/accessory business was that I decided to expand into selling computer supplies and accessories to retail sellers. I sort of had a knack for selling, so thanks to my efforts the business grew very fast. "We Got Ya Computer Supplies Right Here" became one of the largest computer supplies and accessory supplier for the U.S. market.

RA – And Crazy Eddie's is a C corporation that you own 100% of - is that correct?

TP – FORGETTABOUTIT - who else should own it - I built it up from nothing – yeah I own it 100% and always have and always will!

RA - I noticed that back in 2006 and 2007 you used to draw a much larger W-2 salary from CRAZY EDDIE'S "We Got Ya Computer Supplies Right Here" almost zeroing out any NET profit the corporation had so that they did not pay much tax.

POA – now I object to this line of questioning!!!!!!!!! 2006 and 2007 are not under audit and my client doesn’t have to answer any questions about years not under examination!!!!!!!!!

AC – AC jumps in and explains to the POA -----

1. This is not a court proceeding and you have no legal standing here today to allow you to object………………………..
2. The relevance standard under 7602 authorizes the IRS to examine anything that may be relevant to the correctness of Dodger's returns.

Continued on next page

The Script (continued)

3. The RA – Mr. Sharp – is the one who makes the determination as to what questions are relevant to making correct determinations of tax for the years under audit……………
4. The courts have stated that the IRS can get any information that may shed light on the correctness of a tax return and this is a very broad standard.

RA – Mr. Dodger's historical salary with Crazy Eddie's clearly falls within this standard and I need to compare "before and after" facts and Mr. Dodger's relationship with his closely held corporation.

TP – OK - well - Yeah I took a little more in salary before 2008. I own the company. I take what I need. I make the decisions. Look if I take more salary then the corporation pays less tax. Why do you guys care? That way I don't pay tax twice on the same income and besides I earned every dollar of it. Nothing really changed in 2008. I still work almost 14 hours a day. I do everything. My costs are just higher. Everything cost more so I take less in salary because there is less to take. You know how that is?

RA – Mr. Dodger, here are your returns for 2008 thru 2010 – can you verify for me that you signed these returns?

TP – YEAH I signed em

RA – And did you thoroughly review these returns to ensure that they were correct before you signed them?

TP – Well I don't know about that – my CPA Billy "numbers" prepares em and I sign em and forgettabout em.

RA – Mr. Dodger are you aware that you signed these returns under penalty of perjury as to there correctness?

TP – Well yeah I am aware of that ……..so yeah I reviewed em.

RA – And I see that you checked the box on Sch. B indicating that you did not have any foreign bank accounts on all years.

Continued on next page

The Script (continued)

TP – Yeah I've never had any foreign bank accounts.

RA - What information was provided to your CPA to prepare theses returns?

TP – Vader took care of that with BILLY Numbers

RA - The court reporter will mark the copies of the returns as Exhibits 1 thru 3.

RA – Prior to 2008 your corporation was rather profitable if not for the salary that you took? It seems that since 2008 although the sales of your corporation have remained relatively the same the expenses have increased. Also in 2008 and forward your Cost of Goods Sold have gone up disproportionately and the corporation now pays someone for Management/Consulting. Have your duties at the corporation changed beginning in 2008?

TP – FORGETTABOUTIT - I was basically doooooing what I was always doooooooing – runnin the friggin business – ya know I'm a hands on kind of guy. Additionally, Vader here turned me onto a great Management/Consulting Company, Aramahs, LTD., that gave me some good ideas and also referred me to a company, Cayman Finance, LTD., that could help finance my inventory purchases. That company recommended a new supplier, Regdod LTD., for my inventory as well.

RA - Do you or did you own or control any of the entities that you received the financing for your corporation's inventory or for which you paid a fee for Management/Consulting or from which Crazy Eddie's purchased goods for resale?

TP - No.

RA - Did you know who the owner's of those companies are or were?

Continued on next page

The Script (continued)

TP - No. Vader here referred them to me and whatever Vader recommends seems to work out great so I follow his advice. Vader advises me on business options and provides tax opinions that say everything he advises is completely legit – Vader has saved me a lot of taxes the last 3 years

RA - Have you provided Mr. Vader with a written waiver of conflict of interest regarding his representation of you before the IRS and any offshore transactions/arrangements he advised you to use?

TP - What conflict? - We trust each other - there's no conflict -we don't need anything in writing. Besides he told me if his advice didn't hold up he would refund some of the fees I paid.

AC – LL Eagle asks a number of questions regarding reliance defenses under IRC 6664

1. Did you get a tax opinion from a CPA or attorney not involved with Vader's law firm?
2. Who did you rely on to ensure that your tax returns were correct after becoming involved in any offshore financing or any offshore transactions/arrangements that Vader provided advise with?
3. etc. etc.

I don't need anybody besides Vader – he's the best friggin attorney in the NY area – saved me a ton a money!!!!

RA – Speaking of promo materials and tax opinions did you bring all of the documents that were requested in the summons with you today

POA – We have provided some bank records by mail – the rest of the documents requested are all attorney client privileged or are already in the possession of the IRS.

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The Script (continued)

AC – We are going to need a detailed privilege log with a description of each document so that we can ascertain whether the privilege applies - the log needs to include:

1. A general description of the document - including
2. The date the document was produced
3. The name of the person that produced the document
4. The identity of who the document was addressed to
5. The subject of the document
6. And a list of all persons who have seen or reviewed the document

AC – We will also need a listing of all documents responsive to the summons that you contend are in the possession of the IRS – the summons language was specific that you need not provide any document already in our possession.

POA – YEAH - YEAH - YEAH - look I'll see what I can do – that may take 6 or 7 months to prepare due to my schedule.

AC – Mr. Vader - I would like to remind you that circular 230 requires prompt disposition of pending matters and this privilege log would fall into that category

We will set a deadline of 30 days and will seek enforcement of the summons if either the documents or the document logs are not provided by that deadline.

RA - Mr. Dodger I see that beginning in 2008 after Mr. Vader advised you on an offshore company to provide financing for Crazy Eddie's "We Got Ya Computer Supplies Right Here" inventory purchases and also on an offshore company to provide Management/Consulting services to the corporation, your salary from Crazy Eddie's dropped dramatically. Why did your salary decrease so much since 2008?

TP - As I already told you the corporation was paying out a lot more. They had increased expenses and therefore there was less left for me to take such a large salary. Not that I'm not worth it.

Continued on next page

The Script (continued)

RA - You have stated that you paid Management/Consulting Fees to Aramahs, LTD, which is a Cayman Island corporation. Did you have control or access to these funds after they were paid to this company that provided Management/Consulting services to Crazy Eddie's?

TP - OH No! How could I have? That's not my company.

RA - Mr. Dodger were you able to direct where any funds in Aramahs, LTD. were invested or were there any side agreements that some of those funds that were paid by Crazy Eddie's would wind up coming back to you or the corporation?

POA – I OBJECT TO THIS LINE OF QUESTIONING!!!!!!!!!!

AC – Mr. Vader may I (strongly) remind you that you cannot object and continue to disrupt the interview – if you persist in disrupting the interview you will be asked to leave - circular 230 governs your conduct and under circular 230 you may not interfere with an IRS effort to obtain information - your continued interference could also result in a referral to the office of professional responsibility.

POA – Well if I leave Dodger leaves with me!!!!!!!!!!!!!!

AC – That's your client's choice but we will finish this interview today or on another day

TP - Vader, lets just get this damn thing over with – I don't want have to come back here again.

RA – Mr. Dodger – here is exhibit 4 – bank wire transfer documents showing wire transfers to an entity called "No Tax Ltd" in Nevis from Mr. Vader's Management/Consulting Company, Aramahs, LTD, in the Cayman Islands – can you explain to me what the entity "No Tax Limited" is?

TP – FORGETTABOUTIT - never heard of it. And as I stated I don't own Aramahs, LTD. so how would I know what they do with their money?

Continued on next page

The Script (continued)

RA – Mr. Dodger – here is exhibit 5 – this is a UCC1 filing showing loan documents from Cayman Finance LTD refinancing your $4 mil mortgage with NY bank on your personal residence.

POA – Hold on just a minute here!!!!!!!!!!!!!! Where did these documents come from – you can't use documents from another investigation unrelated to my client as exhibits!!!!!!!!!!!!!! I object!!!!

AC - (provides a last warning to the POA) You cannot object and explains the provisions of 6103 (h)(4) – the "need to know rules" and the "transactionally related" provisions and "pattern evidence" provisions of the new REV PROC

POA - I guess I'll just sit here and shut up then!

RA - Would you please answer the last question Mr. Dodger?

TP – Oh sure - Vader recommended this great loan company to me – got some great terms on the re-fi and the line of credit for the business.

RA – And the source of the $6 million in loans is not the money that was paid offshore by Crazy Eddie's to Aramahs, LTD, as Management/Consulting fees?

T/P – Forgettaboutit - no way – just a great Cayman finance company – Vader hooked me up.

RA – Mr. Dodger. You have stated that you have no offshore financial accounts of any kind from 2008 thru 2010 – is that correct?

TP – That's right – no offshore accounts....

RA - Mr. Dodger you also stated that you do not have access or control of any of the Funds in Aramahs, LTD nor are you able to direct where any funds in Aramahs, LTD. were invested and there were no side agreements that some of those funds that were paid by Crazy Eddie's would wind up coming back to you or the corporation?

Continued on next page

The Script (continued)

TP- Yeah - I told you that already - do you have a hearing disability?

RA – Mr. Dodger, you also stated that you have never heard of a Nevis company named “No Tax Limited” – is that correct?

TP – I already answered that question too – no never heard of it.

RA – Mr. Dodger – do you own or control “No Tax Limited”?

POA – This is ridiculous - my client has already answered these questions!!!

RA – No Mr. Vader – this is the first time I asked Mr. Dodger if he owned or controlled “no tax limited”

RA – Mr. Dodger would you like me to repeat the question?

TP – How can I own or control something I have never heard of – the answer is no! You guys aren't the swiftest bunch.

RA – And finally Mr. Dodger – is it your contention that the funds you borrowed personally for your mortgage re-fi and for the line of credit for crazy Eddie's "We Got Ya Computer Supplies Right Here" from Cayman Finance LTD are not the same funds placed offshore as part of your offshore arrangement ?

TP & POA together in unison: What arrangement? There's no arrangement. Cayman Finance LTD. is an unrelated legitimate finance company.

RA - In reviewing your invoices for purchases, I noticed that you switched suppliers in 2008 to another Cayman Island Co, Regdod LTD. In taking a tour of you business I couldn't happen but notice that all of the products I saw were made in Japan, none were made in the Cayman Islands.

Also I noticed that your CGS has increased significantly over prior years.

Continued on next page

The Script (continued)

TP - Cayman Finance, Ltd. hooked me up with this new company. They have a better quality of product and of course my costs have gone up. Everything you buy today has gone up? Again, I pay Regdod for these goods, I don't know if they make them or where they get them from.

RA - Do you have any interest in Regdod, LTD?

TP – Of course not –Regdod, LTD is an unrelated legitimate computer supply company.

RA - Mr. Dodger, I just happen to notice that Regdod is Dodger spelled backwards. Do you still maintain that Regdod, Ltd., to whom Crazy Eddie's pays for their purchases of inventory, is not owned or controlled by you directly or indirectly?

TP - You spent too much time in the 60's with back masking those Beatles Albums. I guess Regdod is Dodger spelled backwards, but so what?

RA – OK Mr. Dodger, I would like you to take a look at some documents that we obtained from chuck cotton swab brokerage pursuant to a summons that was issued for you personal and business stock accounts – these will be exhibit 6

TP – Did you talk to Chuck? – he’s a good egg! We go way back!

RA – Actually yes I did have a discussion with Mr. Swab to explain to him what the terms control and nominee ownership meant – that is when he decided to amend his original response to our summons by adding this account in the name of “No Tax Ltd.” – Mr. Swab contends that you actually control and trade this stock account as a nominee – is that true Mr. Dodger?

TP – Well that no-good back stabbing………….no he’s evidently made a mistake……I will have to talk to him about this

Continued on next page

The Script (continued)

RA – Mr. Dodger I also contacted a former employee of Crazy Eddie's "We Got Ya Computer Supplies Right Here" – a Mr. Bean – the former asst. controller – he has signed a sworn statement that you have used an offshore credit card account to access funds for Crazy Eddie's– he also stated that you bragged around the office that “only little people pay taxes” - we will enter his statement as exhibit 7 – can you explain his statement for me?

TP – Well I fired that no good beans counter – he’s a liar just trying to get back at me for firing his sorry butt!

POA – (heated) What gives you people the right to go around talking to outsiders about a confidential tax case??????? I have got a mind to file complaints against all of you!!!!!

AC – Now calm down Mr. Vader - Counsel explains that the use of 3rd party contacts is allowed when the RA determines that the contacts are necessary to confirm or rebut facts –

1. Cite RRA 98 and IRM here for POA
2. Publication 1 was provided to Dodger and it explained that 3rd party contacts may be necessary

RA – Mr. Dodger here is exhibit 8 showing an offshore debit/credit card account in your name at Cayman Bank and Trust – the documents also show that you were using this card to pay the mortgage on your house (before the re-fi), buy groceries, gas, building materials at Home Depot for $70,000, and a mink coat for $100,000 that was shipped to a Peggy Sewer in Atlantic City.

By the way I interviewed, Ms. Sewer and she had an awful lot of information about your offshore finances – you’re married aren't you Mr. Dodger?

TP - You did what!!!!! Why you............................

Among other things - can you explain this offshore account to me and why it was not reported on your tax returns?

Continued on next page

The Script (continued)

POA – Let me explain this – this is a benefit that is offered as part of the financing program by Cayman Finance Ltd. the finance company. It……………………

AC – Mr. Vader we are here to take the testimony of your client – not your testimony – your client must answer the questions – if you continue to interrupt you will be asked to leave these proceedings

RA – Mr. Dodger will you please answer the question?

POA – Dodger is not answering any more questions today or any other day – we are leaving!!!! This interview is over!!!!

AC – Be advised that we are not finished with our questions and that if your client leaves now we will be forced to compel him to appear on another date to finish the interview. If necessary we will ask the Department of Justice to continue enforcement proceedings immediately and your client will be right back here under a threat of contempt. Are you sure you want to stop the interview?

POA – Let me talk to my client outside for a moment

LATER………………………….

POA – Ok we are ready to proceed

RA – What is the nature of your financial relationship will MS. Sewer?

TP – I decline to answer under the rights provided to me by the 5th amendment of the United States constitution

RA – OK Lets move on – Mr. Dodger what is your involvement with Regdod Ltd and Aramahs Ltd located in the Cayman Islands.

TP – I decline to answer under the rights provided to me by the 5th amendment of the United States constitution

END OF INTERVIEW