MEMORANDUM

4.5/5

FROM: [redacted]
TO: Tax Partner
DATE: April 27, 2012
RE: U.S. federal income tax consequences of Mr. Johnson's redemption of his stock.

FACTS

Mr. Johnson is a U.S. citizen. He purchased 100 shares of InvestCo, Ltd. (a hedge fund formed as a corporation in Cayman Islands) stock for $1 million on January 1, 1995. At that time, InvestCo had 1,000 shares of stock outstanding, the remainder of which were held by foreign individuals. InvestCo only invests for long-term growth of the fund. Its assets consist entirely of property that produces passive income. During the time that Mr. Johnson owned his stock, InvestCo made no distributions.

In 2011, InvestCo sold certain of its assets in order to buy back a portion of its stock from shareholders. Since the sale was at a loss, InvestCo has no accumulated earnings and profits in 2012. In February 2012, InvestCo made a distribution of $150,000 to each of its shareholders in redemption of 10 shares of its stock. For tax purposes, this redemption of stock will be treated as a distribution to which § 301 applies. § 302(d). Mr. Johnson will not be taxed by any foreign country with respect to the redemption of his stock.

Both InvestCo and Mr. Johnson are calendar year taxpayers. The stock of InvestCo is not publicly traded, and InvestCo has refused to comply with the information-reporting requirements that would allow Mr. Johnson to make a QEF election.

ISSUES

What are the U.S. federal income tax consequences of the

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redemption of his stock.

CONCLUSION

Even though the redemption of his stock constitutes return of capital, Mr. Johnson will still be subject to § 1291 excess distribution rules. Generally speaking, this means that Mr. Johnson must treat his $ 50,000 gain from the redemption as being earned ratably over the time he held the stock and pay an interest charge as if he had reported that income in the previous years but had not paid the tax.

DISCUSSION

Applicability of PFIC provisions

A U.S. taxpayer who invests in a non-U.S. corporation generally is taxed on gain from the sale of the stock of that corporation at capital gain rates. This result is altered, however, if the corporation is a "passive foreign investment company" (PFIC). A PFIC is generally any non-U.S. corporation if (a) at least 75% of the corporation's income is certain passive income; or (b) at least 50% of its assets produce such passive income. § 1297.[1] An offshore hedge fund, like InvestCo, is typically treated as a PFIC because almost all of its income is passive and all of its assets generate such income.

Generally speaking, a U.S. taxpayer, like Mr. Johnson, who invests in a PFIC hedge fund, can avoid certain adverse tax consequences if he makes the mark-to market or qualified electing fund (QEF) election. §§ 1293-96. But unfortunately, InvestCo is neither publicly traded nor willing to comply with the information-reporting requirements, which makes Mr. Johnson unable to make either election. As a result, the § 1291 excess distribution rules will apply to Mr.

[1] Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

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Johnson's stock redemption as default.

Taxation of excess distributions

Tax liability under the excess distribution rules arises only when an actual distribution is made, or when the taxpayer actually disposes of stock in the PFIC. § 1291(a). The rules operate by imposing a complicated system of taxation on "excess distribution", which includes all gain from dispositions of stock in a particular PFIC, plus the excess portion of actual distributions from that same PFIC. § 1291(a)(1) and (2). A disposition is any transaction or event that constitutes an actual or deemed transfer of property for any purpose of the Code, including § 302(a) redemption. Prop. Treas. Reg. 1.1291-3(b)(1). In the present case, Mr. Johnson purchased the 10 shares of stock for $ 100,000, sold back to InvestCo for $ 150,000, and thus realized a "gain" of $ 50,000. As discussed above, all the $ 50,000 should be treated as excess distributions.

Once the amount of the excess distribution has been determined, it must be allocated ratably to all of the days the taxpayer held the stock. The portion allocated to the current taxable year is simply included in the taxpayer's gross income for the current year as ordinary income. § 1291(a)(1)(b). The portion allocated to days during which the corporation was a PFIC prior to the current taxable year is taxed at the highest tax rate for the year to which it is allocated, and draws an § 6621 underpayment rate interest charge. § 1291(c). The tax and interests so determined are added to the tax liability for the taxpayer's current taxable year. § 1291(c)(1).

Applying the method mentioned above to the present case, Mr. Johnson's $ 50,000 gain will be ratably allocated to each of the 12 years during which he held the 10 shares of stock. The amounts allocated to current taxable year 2012 will be included in Mr. Johnson ordinary income, which can be offset by losses and expenses he incurred in 2012. In contrast, the amounts

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allocated to each of the prior taxable years will be multiplied by the highest rate of tax applicable for that year and then interests will be calculated accordingly. The sum of that tax and interest will contribute directly to Mr. Johnson's tax liability in the current taxable year 2012.

A little bit of constitutional analysis

One unusual feature of the § 1291 rules is that they apply without regard to earnings and profits. Prop. Treas. Reg. 1.1291-2(c).[2] In practice, when a non-electing PFIC that does not have any earning and profit makes a distribution that is an excess distribution, U.S. investors will be taxed on a return of their capital, rather than on income. And that is the situation of the present case. Because of global financial crisis and the sale of asset at a loss, InvestCo's value decreased a lot and there was little accumulated or current year earning and profit during Mr. Johnson's holding period. As a result, what Mr. Johnson received from the redemption was actually return of capital.

Although this result raises some constitutional concerns under the doctrine of *Eisner v. Macomber*,[3] the IRS has chosen to side step it in the regulations. In the Preamble to the Regulations, the IRS states "if the earnings and profits can be calculated, the shareholder can avoid the disadvantages under § 1291 by making the QEF election". 57 Fed. Reg. 11025(4/1/92). The implicit position here seems to be that the shareholder has voluntarily waived any constitutional protection against taxation of return of capital if he does not make a QEF election.

Therefore, as discussed above, our client Mr. Johnson will still be taxed on his $ 50,000 gain according to § 1291 excess distribution rules.

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[2] See also § 301, a distribution with respect to stock may include (a) the distributor's earnings and profits (E&P); (b) if no E&P remains, return of capital to the extent of basis; and (c) if no E&P or basis remains, then capital gain.

[3] Since the effect of the application of Section 1291 is to levy a tax on a return of capital, it may constitute an unconstitutional taking of property. 252 U.S. 189, 213 (1920).

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MEMORANDUM

FROM: [redacted]
TO: Professor Infanti
DATE: April 4, 2012
RE: Tax Consequences to FC of Ms. Smith's Fact-Finding Mission and Serving as Interim CEO

Facts

ForCo, Ltd. ("FC") is a foreign corporation that is a resident of a country that has entered into a tax treaty with the United States, which has identical terms to those in the U.S. Model Income Tax Treaty. FC is a "qualified person" under Article 22 of the treaty, and is therefore eligible for the benefits under the treaty. FC manufactures widgets in its country of residence. FC also operates a widget manufacturing business in the United States through a wholly owned U.S. subsidiary, SubCo, Inc. ("Sub"). FC recently sent one of its vice presidents, Jane Smith, to the United States to investigate the operations of Sub. Ms. Smith went to the United States on a three-week "fact-finding" mission. Following her visit, Ms. Smith recommended that the CEO and management team of Sub be replaced. FC accepted that recommendation and will terminate Sub's CEO. FC would like Ms. Smith to serve as an interim CEO for Sub. Ms. Smith will remain in the United States for one year, during which she will replace Sub's management team and get Sub's operations in good order. During such time, Ms. Smith will remain a vice president of FC.

Conclusion

FC will likely not be subject to any U.S. tax from Ms. Smith's three-week fact-finding mission. FC will likely be subject to U.S. tax from Ms. Smith's service as the interim CEO of Sub, but FC may be able to minimize its tax consequences for such service.

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Discussion

Under the Internal Revenue Code, FC will be taxed on income that is effectively connected to a trade or business that it conducts in the United States. §§ 882, 864(c).[1] Under the tax treaty, FC will be taxed on business income that is attributable to a permanent establishment in the United States. Arts. 5,7.[2] FC can choose to apply either the Treaty or the Code, whichever is most beneficial, but that choice will apply to all of its business income. Rev. Rul. 84-17.

I. Under the Code, FC likely will not be engaged in a U.S. trade or business and will not be subject to taxation on Ms. Smith's three-week fact-finding mission.

Generally, one must be engaged in regular, continuous and considerable activity to be engaged in a trade or business. *See Cont'l Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959). The performance of personal services is a trade or business unless the person is in the United States for less than 90 days and the compensation for the work is less than $3,000. § 864(b). Ms. Smith was present in the United States for three weeks, or 21 days, performing personal services on behalf of FC. Ms. Smith's presence in the United States was not regular or continuous as she did not continue to visit the United States for examination of Sub's operations after her initial visit. As long as FC does not receive more than $3,000 in compensation from the personal services performed on its behalf by Ms. Smith, it will not be engaged in a trade or business within the United States and will not be subject to tax for her brief visit.

II. Under the Treaty, FC will not have a permanent establishment and will not be subject to taxation on Ms. Smith's three-week fact-finding mission.

A foreign corporation may have a permanent establishment if it has a dependent agent, which includes an employee, in the United States. Art. 5(5). The agent's presence in the United States must be more than "merely transitory" to constitute a permanent establishment. OECD

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury Regulations promulgated thereunder.
[2] Unless otherwise indicated, all article references are to the U.S. Model Income Tax Treaty.

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Commentary of Art. 5, ¶ 33.1. In addition, a permanent establishment generally has not been found to exist when it is for a period of less than six months. *Id.* at ¶ 6. Ms. Smith, as an employee, acted as an agent of FC during her brief visit to the United States. However, Ms. Smith was present in the United States for only three weeks, which may be transitory. Because Ms. Smith's visit was likely transitory, and it was a period of less than six months, it is unlikely that FC will be considered to have a permanent establishment in the United States. FC, therefore, will not be subject to U.S. tax on its income arising from Ms. Smith's three-week visit.

III. Under the Code, FC will likely be engaged in a U.S. trade or business and will be subject to tax on all effectively connected income from Ms. Smith's term as interim CEO of Sub.

A person will be engaged in a trade or business within the United States if its business activities are regular, continuous and considerable. *See Cont'l Trading, Inc., supra*; *U.S. v. Balanovski*, 236 F.2d 298 (2d Cir. 2006). Physical presence is not necessary; acting through an agent can constitute a trade or business, as long as the agent's activity is regular, continuous and considerable. Rev. Rul. 70-424. If the activity between the agent and the person is conducted at arms-length, the agent likely will not be such that will subject the person to a trade or business in the United States. *See Handfield v. Commissioner*, 23 T.C. 633 (1955). Ms. Smith will likely be an agent of FC while she is in the United States. She will be in the United States for at least one year, during which time she will be conducting regular, continuous and considerable activity in the United States. Although Ms. Smith will be an interim CEO for Sub, she will remain an employee that will likely also be conducting business for FC during that time. If Ms. Smith conducts business for FC, as well as Sub, during her stay in the United States, FC will have a trade or business in the United States during that year. FC will thus be taxed on any income

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attributable to Ms. Smith's activity in the United States, including foreign source income that is attributable to Ms. Smith's use of Sub's office. *See* § 864(c)(4).

IV. Under the Treaty, FC will likely have a permanent establishment and will subject to taxation from Ms. Smith's term as interim CEO of Sub.

The ownership and/or control of a subsidiary in itself does not constitute a permanent establishment. Art. 5(7). In order to have a permanent establishment there must be a fixed place of business through which the business of the enterprise is wholly or partly carried on. Art. 5(1). If there is no fixed place of business, a permanent establishment can also be found through the use of a dependent agent. Art. 5(5). Conducting business through an independent agent, however, will not constitute a permanent establishment. Art. 5(6).

An employee who uses an office of another company, such as a subsidiary, for a period of time to ensure that such company complies with its obligations under contracts with the employee's company may be considered a fixed place of business, and therefore a permanent establishment. OECD Commentary of Art. 5, ¶ 4.3. The office used by an employee must have a certain degree of permanency and must be at the employee's disposal for a sufficiently long period of time. *Id.* at ¶ 6. The business carried on through the fixed place of business should be carried on mainly by those in a paid-employment relationship with the enterprise. *Id.* at ¶ 10.

A dependent agent who conducts business for an enterprise will constitute a permanent establishment if the scope and nature of the agent's activity involves the enterprise. OECD Commentary of Art. 5, ¶ 32. To be a permanent establishment, the dependent agent must have and regularly exercise the authority to conclude contracts on behalf of the enterprise. *Id.* An agent will be independent if he or she is legally and economically independent from the enterprise, and the agent is acting in his or her ordinary course of business. *Id.* at ¶ 37; *See also Taisei Fire & Marine Ins. Co. v. Commissioner*, 104 T.C. 535 (1995).

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While serving as the interim CEO of Sub, Ms. Smith will be occupying the offices of Sub. Ms. Smith will be making sure that Sub's operations come to be and remain in good order, likely to comply with obligations as FC's wholly owned subsidiary. Ms. Smith will remain in a paid-employment relationship, as a vice president, with FC during this time. Ms. Smith's term as interim CEO will last for at least one year, which is likely sufficient permanency for her use of Sub's office to constitute a fixed place of business. FC will, therefore, have a permanent establishment in the United States through Ms. Smith's use of Sub's offices.

If Ms. Smith's use of Sub's offices is not found to be a fixed place of business, her presence in the United States may still constitute a permanent establishment as a dependent agent of FC. As a vice president, Ms. Smith likely has the authority to conclude contracts on behalf of FC. If she regularly exercises such authority while she is in the United States serving as an interim CEO, Ms. Smith will be a dependent agent and will constitute a permanent establishment under Article 5(5). Ms. Smith will not be an independent agent because she will likely be subject to the external control of FC and she likely will not be bearing the risk, unlike the agent in *Taisei Fire & Marine Insurance Company*.

V. FC can minimize taxation in the United States.

FC can minimize taxation if Ms. Smith's employment with FC is terminated during the one year period in which she is present in the United States as the interim CEO of Sub. FC would also have to make sure that Ms. Smith will be treated as an independent agent, rather than a dependent agent during that time. To be treated as an independent agent, Ms. Smith should have discretion over the day-to-day operations, not be subject to external control, and bear the risk of loss for the business activities. *See Taisei Fire & Marine Ins. Co., supra.*

A.M.G.

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4.25/5

MEMORANDUM

FROM: [redacted]
TO: Anthony C. Infanti, Senior Partner
DATE: April 4, 2012
RE: ForCo, Ltd.

FACTS

ForCo, Ltd. ("FC") is a foreign corporation engaged in the manufacture of widgets in its country of residence.. FC also operates a widget manufacturing business in the United States through a wholly owned U.S. subsidiary, SubCo, Inc. ("Sub"). Recently, FC sent one of its vice presidents, Jane Smith, on a three-week fact-finding mission to the U.S. to investigate Sub's operations. Due to problems with the management of Sub, FC wishes to install Ms. Smith as a short-term replacement for Sub's CEO. FC envisions Ms. Smith remaining in the U.S. for one year, where she will work to replace Sub's management team and bring Sub's operations into good order. Ms. Smith would remain a vice president of FC during this time.

nice, short statement of facts

ISSUES

1. What are the U.S. federal income tax consequences to FC ~~based upon~~ of Ms. Smith's three-week fact-finding mission in the U.S.?
2. What would the U.S. federal income tax consequences be to FC if ~~they~~ it sends Ms. Smith to serve as interim CEO of Sub? What steps, if any, could FC take to minimize any adverse tax consequences to it that might arise from Ms. Smith serving as interim CEO of Sub?

CONCLUSION

1. It ~~is very unlikely that~~ the three-week fact-finding mission carried out by Ms. Smith will probably not result in any U.S. federal income tax consequences to FC so long as her activities were limited to collecting information.
2. If FC were to install Ms. Smith as CEO of Sub without releasing her from her position at FC, this could cause the IRS or a U.S. court to disregard Sub's status as an independent U.S. corporation

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and subject FC to U.S. federal income tax consequences. In order to avoid this possibility, FC should remove Ms. Smith from her position as vice president at FC for the duration of her tenure as CEO of Sub.

DISCUSSION

I. Ms. Smith's three-week fact-finding mission

Analysis under the Code: Foreign corporations are subject to U.S. federal income tax on their income that is effectively connected with the conduct of a trade or business within the United States. § 882(a)(1).[1] Whether a foreign corporation is engaged in a trade or business within the U.S. is a question of fact, and courts generally look to whether the foreign corporation is engaged in regular, continuous, and considerable business activity within the U.S. Treas. Reg. § 1.864-2(e); Pinchot v. Commissioner, 113 F.2d 718, 719 (2nd Cir. 1940). Isolated or sporadic transactions, meanwhile, will not usually be construed as the conduct of a U.S. trade or business.

Under the Code, Ms. Smith's three-week fact-finding mission in the U.S. would likely be deemed an isolated and sporadic activity, and not the kind of regular, continuous, or considerable activity necessary to create a U.S. trade or business.[2] Even if Ms. Smith's trip were deemed to have established a U.S. trade or business on behalf of FC, her activities would not have led to any income effectively connected to such business, so long as her activities were of a preparatory, non-income producing nature. For these reasons, Ms. Smith's trip should not create any U.S. federal income tax implications for FC under the Code.

Analysis under the Treaty: FC is a resident of a contracting state (country) that has entered into a tax treaty with the U.S. that has terms identical to those of the U.S. model income tax treaty. FC is a "qualified person" within the meaning of Article 22 (Limitation on Benefits) of the treaty. Under

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended ("the Code"), or to the Treasury Regulations promulgated thereunder.

[2] See also Treas. Reg. § 1.864-7(b)(2).

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Article 7 of the treaty, the profits of an enterprise of a contracting state shall be taxable in the other contracting state where that enterprise carries on business in the other contracting state through a permanent establishment ("PE") situated therein. U.S.-F.C. treaty, art. 7(1). Article 5 defines a PE as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Id. art. 5(1).

Although Article 5 does not specifically mention whether subsidiary corporations may be considered PEs of their parent corporations, it is very unlikely that the three-week fact-finding mission carried out by Ms. Smith will result in any U.S. federal income tax consequences to FC under the treaty. Where a person acts on behalf of an enterprise in a contracting state in a manner limited to collecting information for the enterprise or any other activity of a preparatory or auxiliary character, such activity will not create a permanent establishment of the enterprise in that state. Id. art. 5(5), (4)(d)-(e). The Treasury Department's technical explanation of the treaty further reiterates that the maintenance of a fixed place of business solely for the purpose of collecting or supplying information will not create a permanent establishment. U.S. Treasury Dep't, Tech. Explanation of US-FC Tax Treaty, art. 5.

According to FC, Ms. Smith was sent to the U.S. to investigate Sub's operations, which led her to discover serious problems with the management of Sub. Although FC should be contacted in order to determine the exact activities of Ms. Smith, it is likely that her activities were purely informational in nature, such as speaking with Sub's management and employees and reviewing Sub's financial records. As long as Ms. Smith's activities during her trip to the U.S. remained passive rather than executive in nature, her activities should not subject FC to any U.S. federal income tax consequences.[3]

II. Ms. Smith as interim CEO of Sub

[3] Even if Ms. Smith's mission were deemed to have established a PE for FC in the U.S., the mission likely did not generate any business profits for FC, which would preclude U.S. federal income taxation. U.S.-F.C. Treaty, art 7(1).

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Under both the Code and the treaty, FC should not be subject to U.S. federal income tax based upon its relationship with Sub, so long as FC does not intervene in Sub's activities in a way that would compromise Sub's separate corporate status. It is somewhat unclear exactly what level of oversight FC may exercise over Sub without subjecting itself to U.S. federal income tax. If FC were to install Ms. Smith as CEO of Sub without releasing her from her position at FC, this could cause the IRS or a U.S. court to disregard Sub's status as an independent U.S corporation and subject FC to U.S. federal income tax on any income connected to Ms. Smith's activities as CEO of Sub.

Under the Code, foreign corporations are subject to U.S federal income tax on their income that is effectively connected with the conduct of a trade or business within the U.S. § 882(a)(1). As Sub is its own corporation, its income from business activities within the U.S. should not be attributed to FC, so long as FC refrains from any sustained and considerable intervention into Sub's business that would call Sub's corporate independence into question. A foreign corporation with income from sources outside the U.S. shall not have such income attributed to a U.S. office where that office is that of an independent agent. § 864(c)(5)(A). A wholly owned U.S. subsidiary of a foreign corporation may be treated as acting in the capacity of an independent agent for its foreign parent, depending on the facts and circumstances of the relationship. Treas. Reg. § 1.864-7(d)(3)(ii)-(iii).

Under the treaty, the fact that a resident of a contracting state controls a company that is a resident of the other contracting state shall not be taken into account in determining whether either company has a PE in that other state. U.S.-F.C. Treaty, art. 5(7). An enterprise shall not be deemed to have a PE in the U.S. merely because it carries on business in the U.S. through an independent agent, provided that such agent is acting in the ordinary course of its business as an independent agent. Id. art. 5(6).

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The IRS has ruled that a U.S. subsidiary of a foreign corporation can be an independent agent. Rev. Rul. 76-322, 1976-2 C.B. 487, 488. The Treasury Department has explained that an independent agent must be both legally and economically independent of its principal enterprise. U.S. Treasury Dep't, Tech. Explanation of US-FC Tax Treaty, art. 5 In The Taisei Fire and Marine Insurance Co. v. Commissioner, 104 T.C. 535 (1995), the United States Tax Court held that the activities of a U.S. subsidiary of a foreign corporation did not represent a PE of the foreign parent corporation because the U.S. subsidiary qualified as an independent agent. Specifically, the court pointed to the subsidiary's legal and economic dependence from the parent. Id. at 556. Even more relevant to FC's case, the court drew attention to the fact that no representative of the parent acted as a director, officer, or employee of the subsidiary. Id. at 552.[4]

If Ms. Smith were to conduct business activities in the U.S. as CEO of Sub while simultaneously remaining in her position as a vice president of FC, there is a possibility that her activities could be construed as establishing a PE on behalf of FC in the U.S. In other words, her activities could be construed as that of a vice president of FC conducting business activities at a PE in the U.S., regardless of her position as CEO of Sub.

Although it may be possible for FC to structure Ms. Smith's duties so as to allow her to hold both positions simultaneously while still avoiding the establishment of a PE or otherwise interfering with Sub's potential status as an independent agent, FC can mitigate this uncertainty by discharging Ms. Smith from her position as vice president at FC for the duration of her tenure as CEO of Sub. Under this structure, Ms. Smith would be an employee/officer of Sub and not of FC and, as such, Ms. Smith's activities would not be attributable to FC for tax purposes.

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[4] See also United States v. Bestfoods, 524 U.S. 51 (1998) (discussing factors to consider when determining whether a U.S. subsidiary should be deemed a separate, independent entity from its foreign parent corporation in the context of environmental liability).

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