

Something Different: An Income Tax “Potpourri” Webinar

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Today's Panel



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Agenda Topics

1. FBAR liability developments
2. Tax Evasion and Foreign Accounts
3. Public Law 86-272 Developments
4. Transfer Pricing Developments
5. Sale of U.S. Partnership Interests by Foreigners
6. Conservation Easements Developments
7. COVID Exclusions for “Residency” Determinations
8. Federal 2021 Inflation adjustments
9. The Future of the “Arm’s-Length” Standard?

Agenda Timing

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FBAR liability developments	3
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The Future of the “Arm’s-Length” Standard?	6
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Learning Objectives

- After viewing this webinar, attendees will be able to describe various recent federal, state and international income tax developments
- Attendees will better understand new transfer pricing information and opportunities for application in state tax planning
- Attendees will be able to identify some federal tax issues triggering unexpected valuation, reporting and commercial transaction reviews
- Attendees will be able to discuss year-end residency “day count” planning issues

Polling Question #1

Have you ever purchased potpourri?

- A. Yes, all the time.
- B. Once, for my mother.
- C. No.
- D. What is “potpourri”?

1. FBAR Liability Developments

FBAR Filing Requirements

- FinCen Form 114 (“FBAR”) is filed annually (by Oct. 15th) of the following year
- Not filed “with” the tax return, but separately and electronically
- Required filers must report comprehensive information about all foreign bank and financial/investment accounts when they have:
 - A “financial interest” and
 - “Signature” or other authority.
- Taxpayers must identify on Schedule B whether they have reportable foreign accounts and include investment income
- FBAR penalties: \$10,000 per account per year, and worse...

FBARs (cont.)

- FBAR filing traps:
 - Filing required if *all* such accounts aggregate at least US\$10,000 value on *any day* of the year (all foreign are reportable, even the small ones...)
 - You co-own a reportable account with your spouse; you each have to report it
 - Co-ownership of family/aged parent foreign account (being put “on” the account, with or without knowledge)
 - You are signatory on foreign business account(s) of your company or foreign affiliate (still reportable personally, but as signature/no beneficial interest)
 - You are in “control” of the foreign entity, or of a domestic entity, that has foreign accounts even if you personally do not have official signature authority
 - You can pick up the phone and the foreign bank will follow your directions as to the account
 - The foreign bank requires two or more authorized signatories to direct the funds; each such (US) signatory must still report that account
 - The primary owner dies and has failed to disclose an FBAR reportable account...

FBARs (cont.)

- What happens if the taxpayer who owns the reportable FBAR account dies, but has failed to report it – and the IRS comes after his/her executor, etc.?
 - Cases have held that the FBAR penalties like other tax penalties do not disappear with the death of the taxpayer
 - The executors/personal representatives may be substituted as defendants, as may co-owners who inherit the account (e.g., spouses) and the estate itself
 - Distribution of funds from undisclosed accounts as part of probate may also lead to assessment of penalties against the distributees, etc.
 - NOTE: the FBAR penalties are in addition to the failure to report investment earnings and entity ownership for income tax purposes

2. Tax Evasion and Foreign Accounts

Tax Evasion and Foreign Accounts

- Robert Brockman is CEO of automotive software-maker Reynolds & Reynolds (which acquired his firm, Universal Computer Systems), and is worth billions...
- He was the sole investor in the first PE fund managed by Vista Equity Partners, co-founded by Robert Smith and Brian Sheth 20 years ago
 - Today, Vista Equity has some \$73 Billion under management
- Brockman used undisclosed foreign accounts/income to funnel money over the years into that PE fund (some \$2 Billion)
 - Brockman's software industry knowledge helped Smith's fund make significant profits, and Smith became a billionaire personally
 - Smith did not report substantial income from his offshore fees and investments

Tax Evasion and Foreign Accounts (cont.)

- Smith used his accumulated, undeclared funds to establish a sizable charitable foundation, which funded many worthwhile activities:
 - National Parks, breast cancer research, Carnegie Hall renovations, foster children and underprivileged youth assistance, etc.
- Robert Smith maintained accounts at UBS; when the bank advised in 2014 that it was complying with DOJ requests to disclose accounts of US taxpayers, he submitted but was rejected for the OVDP program...
- Robert Smith's Plea Deal (Oct. 2020) with DOJ:
 - He admitted willful evasion of \$43 Million in Federal taxes, and will continue to cooperate in the Robert Brockman investigation
 - He will pay \$139 Million in fines/penalties, and withdraw refund requests for \$182 Million for charitable deductions

Tax Evasion and Foreign Accounts (cont.)

- Recently (Nov. 2020), Smith and his Vista co-founder, Brian Sheth, agreed that Sheth would leave Vista:
 - Sheth would surrender his minority interest in Vista, but keep his entitlement to various performance fees and be released from various non-compete provisions
- So, who is Robert Smith?
 - He's been called "America's Wealthiest African American"
 - He moved to Switzerland in 2010
 - In 2014, he married the 2010 Playmate of the Year
 - In 2016, he was elected Chairman of the Carnegie Hall Board of Directors
 - Charles Rettig was one of his earlier lawyers, and...

Tax Evasion and Foreign Accounts (cont.)

- ... at the 2019 Commencement at Moorhead College in Atlanta, he pledged to, and did, pay off all student debt held by all those graduates and their parents, a total of \$34 Million...

3. Pub. Law 86-272 Developments

Pub. L. 86-272 (1959)

- *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959)
 - U.S. Supreme Court affirmed Minnesota’s imposition of income tax on an Iowa cement company
 - Only activities were solicitation of orders for the sale of products; each order was accepted, filed, and delivered from Iowa
- Public Law 86-272 passed 9 months later as a “temporary measure pending a deeper review of state taxation” ; Safe Harbor
- When a federal statute and a state statute are in conflict, the federal law preempts the state law pursuant to the Supremacy Clause of the U.S. Constitution

Pub. L. 86-272: Interstate Commerce

- Applies only to net income taxes
- The only protected “business activity” in the state is the solicitation of orders for sales of tangible personal property
- The orders solicited in the state must be
 - sent outside the state for approval
 - filled by shipment from delivery outside the state

Wrigley (SCOTUS 1992)



- U.S. Supreme Court interprets PL 86-272
- William Wrigley, Jr., Co. – “world’s largest manufacturer of chewing gum”
- Clarified that “solicitation” activity includes “ancillary activities”
 - Serve no independent business function apart from soliciting of orders
 - Examples: in-state recruitment, training, and evaluation of sales representatives; use of hotels and homes for sales-related meetings
- “De minimis” non-solicitation activities permitted
 - Cannot establish a nontrivial additional connection
 - Cannot be activities that constitute a “matter of regular company policy” conducted on a “continuing basis”
 - Not measured by importance or by dollar impact

Does Pub. L. 86-272 Apply to Foreign Commerce?

- Multistate Tax Commission: yes
- States: no consensus

Foreign Commerce - Treaty Protection

- Treaties:
 - Effectively connected income
 - e.g., internet-based transactions that do not require a Permanent Establishment (PE) can create broad protections from federal income tax
- States generally not parties to U.S. tax treaties
- Avoid federal income tax but not state income tax

State Income Tax Starting Points

- Taxable income as defined in IRC
- Recalculate income as if no treaty
 - *or* state-level PE requirement
- Income only excluded if relevant treaty eliminates *all* income from tax

Foreign Commerce & Pub. L. 86-272

- Does not expressly apply to foreign commerce
- MTC advises states to apply PL 86-272 to both foreign and interstate commerce
- Only applies to net income tax (e.g., does not limit sales tax)

Foreign Commerce & Pub. L. 86-272

States Extending 86-272

- Illinois
- Michigan
- Montana
- Utah

States Not Extending 86-272

- California

Polling Question #2

- How frequently will you consider Public Law 86-272 in 2021?
 - A. Frequently, at least every quarter
 - B. Occasionally, in planning and year end
 - C. Once – for financial purposes
 - D. Never (unless we have another Potpourri session!)

4. Transfer Pricing Developments

State Transfer Pricing

- Transfer pricing as state concept?
- Yes – any intercompany transactions across jurisdictions
- **Important:** States not bound by IRC Sec. 482
 - **Important:** States not bound by Arm's Length Standard
 - **However:** Most states adopt some semblance of the Arm's Length Standard



State transfer pricing audits have quadrupled since 2015

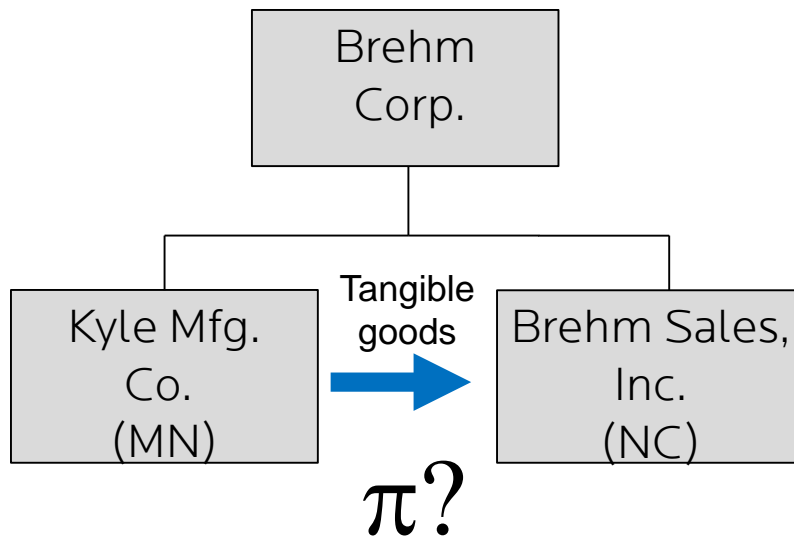
Polling Question #3

- When did you first encounter the phrase “arm’s length”?
 - A. The previous slide
 - B. When I started my career in tax / law
 - C. At University
 - D. As a baby (it is in my DNA)

State Transfer Pricing



Example:



State Transfer Pricing



Example:



Kyle Mfg. Co.	
Sales	64
Cost of Goods Sold	50
Gross Profit	14
Selling, Gen. & Admin.	0
Oper. Profit (EBIT)	14
Tax (Combined)	
Profit	



Brehm Sales, Inc.	
Sales	100
Cost of Goods Sold	64
Gross Profit	36
Selling, Gen. & Admin.	35
Oper. Profit (EBIT)	1
Tax (Separate)	
Profit	



State Transfer Pricing



Example:



Kyle Mfg. Co.	
Sales	100 50
Cost of Goods Sold	50
Gross Profit	100 0
Selling, Gen. & Admin.	0
Oper. Profit (EBIT)	100 0
Tax (Combined)	
Profit	

Brehm Sales, Inc.	
Sales	100
Cost of Goods Sold	50 50
Gross Profit	50 50
Selling, Gen. & Admin.	35
Oper. Profit (EBIT)	15 15
Tax (Separate)	
Profit	



North Carolina Auditor

State Transfer Pricing

- Much more than Combine v. Separate
- Any time intercompany transactions occur across jurisdictions
 - C Corp. v. S Corp.
 - For profit v. Not for profit (Healthcare)
 - Specific tax characterization v. General tax characterization (ESOPs)

State Transfer Pricing History

- Historic State transfer pricing audit focus
 1. Apply arm's length standard
 2. Examine economic substance
 3. Disallow certain deductions
- Audits not just occurring in Combined return states
 - California: Sophisticated transfer pricing regime
 - Utah: *Utah State Tax Commissioner v. See's Candies, Inc.*

State Transfer Pricing Case Example

- *Utah State Tax Commissioner v. See's Candies, Inc.*
 - See's Candies, Inc. (Utah) sold intangible property to related party, Columbia Insurance Company (Missouri)
 - Columbia then licensed IP to See's for royalty
 - Supported by transfer pricing documentation
 - Multistate Tax Commission (MTC) audit
 - 1995 to 1998 – MTC audit recommended lower royalty
 - 1999 to 2007 – MTC audit
 - Utah State Tax Commission disallowed entire royalty deduction
 - Utah State Supreme Court ultimately heard case – sided with taxpayer (2018)

State Transfer Pricing Developments

State limited audit resources

+ State requirement for balanced budgets

Desire for external transfer pricing specialists

- Cottage industry of specialists
 - Law Firms
 - Accounting Firms
 - Boutique Firms

 - Example: Chainbridge Software

State Transfer Pricing Developments

- MTC – 2015 – Arm’s Length Adjustment Service
 - United states interested in transfer pricing
 - Encourage information sharing between member states
 - Train groups for audit
- Later rebranded State Intercompany Transactions Advisory Service (SITAS)
 - Pursued by at least a dozen states, with interest from others

State Transfer Pricing Developments

- North Carolina – 2020 – Voluntary Disclosure Program
 - Opportunity for taxpayers to proactively seek resolution of historical positions
 - Participants will not face penalties
- Indiana – 2020 – Advanced Pricing Agreement Program
 - Opportunity for taxpayers to proactively seek resolution of current/future positions
 - Participants will have certainty sooner
- **Important:** Both programs are generally international concepts
 - What could this mean for the future?
 - Especially when states are not, technically, bound by 482/Arm's length standard

State Transfer Pricing Developments

- *The Coca-Cola Co. vs. Commissioner* (2020)
 - Note: Federal case
- Potential state considerations
 - Coca Cola “Supply Points” interpretation vs. Complexity
 - Legal agreements vs. Economic substance
 - Taxpayer/Authority agreement precedence vs. Non-precedence
- Tax Court sided substantially for the Commissioner
 - Ultimately, if State transfer pricing regulations are similar to Federal regulations (as in *See’s*), will States and State courts draw similar conclusions?
 - Example: Coca Cola “Supply Points” in states
 - Who determines the arm’s length standard?

Polling Question #4

- How frequently have you / your company / clients developed state transfer pricing support in the past?
 - A. More than 10 times
 - B. 6 to 10 times
 - C. 1 to 5 times
 - D. Never

5. Sale of U.S. Partnership Interests by Foreigners

Sale of U.S. P'ships by For. Partners

- Section 741 says that sale of a partnership interest “shall be considered as gain or loss from the sale or exchange of a capital asset”
 - Except for “hot assets” etc., as provided in Section 751
 - Applies to sales of interests in actual partnerships plus LLCs that have not made a CTB election
- Rev. Rul. 91-32 held that, under the aggregate theory, the sale by a foreign owner of a U.S. partnership interest was the equivalent of a proportional sale of assets used in U.S. trade or business, hence treated as ECI (ordinary income) to the extent of gain on the sale of such partnership business assets
- Foreign partners of U.S. partnerships (including LLCs) are engaged in U.S. trade or business if the partnership is so engaged (Section 875(1))

Sale of U.S. P'ship Interests (cont.)

- *Grecian Magnesite* case (149 TC No. 3, July 13, 2017) held that a redemption of the foreign partner was equivalent to a sale of the partnership interest by such owner, and Section 741 controlled (aside from any “hot assets”) to provide capital gains treatment
 - NRAs without U.S. tax nexus, FDAP or ECI are not otherwise subject to US tax
 - Under U.S. source rules, sales of personal property (like partnership interests) are generally sourced to the residence of the seller
- TCJA codified the Revenue Ruling (91-32) in Section 864(c)(8)
 - Thus, unsuspecting foreign partners are subject to direct U.S. tax and filing requirements on their ECI income attributable to “sales” of U.S. partnership assets

6. Conservation Easements Developments

I.R.C. § 170(h)

- Qualified Conservation Contribution
- A contribution of:
 - (A) of a qualified real property interest,
 - (B) to a qualified organization,
 - (C) exclusively for conservation purposes



Filing Requirements

- Qualified Appraisal
 - Treas. Reg. § 1.170A-17(a)
- Form 8283
 - Donee's name and TIN
 - appraiser's name and TIN, FMV
 - manner and date of acquisition by donor
 - Adjusted Basis

Litigation

- ***Englewood Place, LLC*, T.C. Memo. 2020-105** (denying deduction for taxpayer's failure to comply with regulatory reporting requirements)
- ***Belair Woods, LLC*, T.C. Memo. 2018-159** (concluding taxpayer did not comply with regulatory reporting requirements but allowing case to continue on taxpayer's reliance on professional advice defense)
- ***Champions Retreat*, 959 F.3d 1033 (11th Cir. 2020)** (vacating tax court's denial of deduction)

Syndicated Conservation Easements

- Revenue Notice 2017-10:
 1. An investor receives promotional materials that offers prospective investors in a pass-through entity the possibility of a charitable contribution deduction that is at least 2.5 times the amount of the investment;
 2. Promotional materials may be oral or written;
 3. Investor purchases an interest (directly or indirectly) in the pass-through entity that holds the real estate;
 4. Pass-through contributes a conservation easement encumbering the property to a tax-exempt entity and allocates (directly or indirectly) a charitable contribution deduction to the investor; and
 5. The investor reports a charitable contribution deduction on his/her income tax return
- “Substantially similar” transaction

Form 8886

- Penalties for Not Filing:
 - I.R.C. § 6707A – 75% of the reduction in tax reported but not less than \$5,000/\$10,000 and not more than \$100,000/\$200,000; IRS cannot rescind any portion of penalty, *not* judicially reviewable, and “shall be in addition to any other penalty”
 - I.R.C. § 6501(c)(10) – Statute of limitations does not run until one year after the information actually provided to IRS
 - I.R.C. § 6662A(c) – Accuracy penalty up to 30%
- Benefit/Risks for Filing:
 - Avoid penalties
 - Inviting an audit

7. COVID Exclusion for “Residency” Determinations

U.S. “Residency” – Medical Exception

- Treas. Reg. § 301.7701(b)-3(c)(1): “Medical condition”
 - “Not present on any day” if “individual *intends* to leave and is *unable* to leave the U.S. because of a medical condition or medical condition that *arose while the individual was present*” in the U.S. (Emphasis added.)
 - A day is “not excluded” if the individual was initially prevented from leaving, is subsequently able to leave, but remains “beyond a reasonable period for making arrangements” to leave.
- Treas. Reg. § 301.7701(b)-3(c)(3): “a pre-existing medical condition will not be considered to arise while the individual is present ... if the condition or problem [1] *existed prior* to the individual’s arrival ... and [2] the *individual was aware* of the condition or problem...”

U.S. “Residency” – Notice 2020-20

- Section 3.04 grants an *automatic exclusion* of “up to 60 consecutive days” of “presence” in 2020, as selected by the taxpayer starting on/after 2/1/20 through 4/1/20 the “COVID-19 Emergency Period” (CEP) if:
 - NOT a U.S. resident at the close of 2019,
 - NOT an LPR at any point during 2020,
 - Present in the U.S. on each day of the person’s selected CEP, and
 - Does not become a U.S. resident in 2020 for days of “presence” here outside of such CEP
- Section 2.04 requires filing of Form 8843 to claim Medical Condition Exception by due date (with extensions) for Form 1040NR (whether or not the 1040NR is itself otherwise required)

U.S. “Residency” Rules: COVID

Example A:

- 2020 Days Calc. Total
 - Present 250 x 1 = 250 – 60 = 190*
- 2019 Days
 - Present 150 x 1/3 = 50
- 2018 Days
 - Present 90 x 1/6 = 15

TOTAL days of 2020 “Presence”: **255 = US “resid”**

U.S. “Residency” Rules: COVID (cont.)

Example B:

- 2020 Days Calc. Total
 - Present 100 x 1 = 100 - 60 = 40
- 2019 Days
 - Present 150 x 1/3 = 50
- 2018 Days
 - Present 90 x 1/6 = 15

TOTAL days of 2020 “Presence”: 115 = NRA

(Note: even without COVID exclusion, still NRA)

U.S. “Residency” Rules: COVID (cont.)

Example C:

- 2020 Days Calc. Total
 - Present 175 x 1 = 175 - 60 = 115
- 2019 Days
 - Present 150 x 1/3 = 50
- 2018 Days
 - Present 90 x 1/6 = 15

TOTAL days of 2020 “Presence”: 180 = NRA

(Note: not a “resident” at year-end 2019...)

U.S. “Residency” Rules: COVID (cont.)

Example D:

- 2020 Days Calc. Total Present
 90 x 1 = 90 - 60 = 30*
- 2019 Days
 ➤ Present 270^ x 1/3 = 90
- 2018 Days
 ➤ Present 90 x 1/6 = 15

TOTAL days of 2020 “Presence”: 195 = U.S. “resid”?

[**BUT:** 135 days due to COVID exclusion? **NO: See YE 2019 status!**]

Two Minnesota Residency Tests

- Physical Presence Test
 - More than half the year (“> 183 days”) in Minnesota and
 - Maintain place of abode in Minnesota
- Intent or Domicile Test
 - Traditional subjective test
 - 26 objective factors

It is easier to acquire MN residency,
than to terminate it...



Physical Presence Test: No MN Medical Exception



- Proposed legislation to create MN medical exception has **not been enacted**
 - No administrative exception from DOR
- Compare: New York Medical Exception:
 - *Stranahan v. State Tax Commission*, 68 AD2d 250,416 NYS2d 836 (3d Dept 1979): when a nondomiciliary seeks treatment for a serious illness, the time spent in a medical facility for the treatment of that illness not counted toward the number of NY residency days
 - Audit policy: confinement to a medical institution for any reason in New York (serious or otherwise), does not constitute a day spent in New York.

8. Federal 2021 Inflation Adjustments

Foreign 2021 Inflation Adjustments

- Rev. Proc. 2020-45 published various Code-related inflation adjustments for 2021:
 - Expatriation Tax
 - Ave. 5-year net income tax = **\$172,000** [§ 877(a)(2)(A)]
 - Gain exclusion = **\$744,000** [§ 877A(a)(3)]
 - Foreign Earned Income Exclusion = **\$108,700** [§ 911(b)(2)(D)]
 - “Seriously Delinquent Tax Debt” for Passport Revocation = **\$54,000** [§ 7345(f)]

Domestic 2021 Inflation Adjustments

- Rev. Proc. 2020-45 (cont.):
 - Standard Deduction [§ 63(c)(2)]
 - Married/Joint = **\$25,100**
 - Head of Household = **\$18,800**
 - Married Separate/Single = **\$12,550**
 - Qualified Business Income [§ 199A(e)(2)]
 - Married/Joint = **\$329,800**
 - Married/Separate = **\$164,925**
 - All others = **\$164,900**
 - Interest on Educ. Loans [§ 221] = **\$2,500** max; phases out at \$170K (M/J)
 - Max. premiums for micro captives [§ 831(b)(1)] = **\$2,400,000**
 - Unified Credit against Est. Tax [§ 2010] = **\$11,700,000**
 - Tax on Arrow Shafts [§ 4161(b)(2)(A)] = **\$0.53/shaft**

9. The Future of the “Arm’s Length” Standard

Arm's Length Standard: Historically

- Predates transfer pricing (by a long shot):
 - Shakespeare (As You Like It ~1599): “Thy conceit is nearer death than thy powers. For my sake, be comfortable: hold death awhile at **arm’s end**.”
 - Dictionary of English Language (1755): Arm’s length originates from boxing – to hold an opponent at arm’s length for pugilistic advantage
- Transfer pricing = relatively new use of arm’s length
 - Revenue Act of 1921 – not actual words, but beget “arm’s length” language
 - *Seminole Flavor. Co. v. Commissioner* (1945) – transaction seems to be “fair and entitled to classification as an **arm’s length** transaction”

Arm's Length Standard: Historically

- Phrase became the norm: What does it mean?
 - *Frank v. International Canada Corp.* (1962) – refers to the combination of words “arm’s” and “length” as “talismanic”
 - Holding magical/mystical powers
 - *Coca-Cola* (2020): describes an arrangement between related parties in terms of whether it was regarded as the “Platonic” ideal of an arm’s length arrangement
 - Affectionate but not sexual

Arm's Length Standard: Future

- Implication:
- The arm's length standard is open for interpretation
 - US Services Regulations (482-9): Services Cost Method (SCM)
 - Charge certain services at cost and be considered consistent with the arm's length standard
 - Would related parties engage without a profit element?
 - OECD Guidelines: Going “beyond” Arm's Length Standard
 - States may be next to offer interpretation?
 - 50 Different interpretations of “Arm's Length Standard”?

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Thanks!