International Taxation
Working Outline
University of Miami School of Law
Graduate Program (LLM) in Taxation
Fall 2001

I. US Taxation Jurisdiction

A. Citizenship and Residency

1. *Cook v. Tate*

a) the court justified taxation of a US citizen who was a resident of Mexico on the following grounds

(1) the benefits of citizenship extend beyond territorial boundaries

(2) **Note**: citizens have the right to return to the US whenever they want and participate in the economic system - - *a citizen of the US thus has an insurance policy, and* <u>*taxes are the cost of maintaining that policy*</u>

2. *basic definitions*

a) every person <u>born</u> **OR** <u>naturalized</u> in the US **AND** subject to its jurisdiction = US citizen (Reg. §1.1-1(c))

b) noncitizen who has filed a declaration of intention of becoming a citizen but who has not yet been granted citizenship by final order of naturalization court = alien

3. *Who is a resident?*

a) Individuals

(1) If individual meets any one of the following tests

(a) Lawful admission to the US (*i.e.,* "green card" test)

(b) "substantial presence" test

(c) first year election to be treated as a resident (§7701(b)(1)(A))

(d) Note: once permanent residence is obtained → an individual remains a lawful permanent resident until the status is revoked or abandoned

(2) "substantial presence" test

(a) test is met **if**

(i) the individual is present in the US for <u>at least 31 days</u> during the current year **AND** at least **<u>183 days</u>** for the three-year period ending on the last day of the current year <u>using a weighted average</u> (§7701(b)(3))

(ii) weighted average

(a) days present in the current year are multiplied by 1

(b) days present in the immediate preceding year are multiplied by 1/3

(c) days in the next year are multiplied by 1/6

(iii)**<u>key problem causing issue</u>=** the alien will not be considered a resident **IF** it is present in the US fewer than 183 days **AND** <u>has a tax home in a foreign country to which the individual has a closer connection than to the US</u> (§7701(b)(3)(B))

(a) **definition**: *TAX HOME* = considered to be located at a taxpayer's regular or principal place of business or if the taxpayer has no regular principal place of business → at his regular place of abode (§911(d)(3); Reg. §1.911-2(b))

(b) **<u>definition</u>**= "*PRESENT*"

(i) an individual is present in the US any day they are **physically present at any time during the day**

(a) **Note**: the definition "*present*" is subject to a an **exception for**

COMMUTERS = does not apply as a blanket rule to commuters from Mexico and Canada) (§7701(b)(3)(D))

(b) **Note**: DO NOT COUNT any days that the individual was unable to leave the US because of **medical condition** or **days where the individual is a foreign government employee, a teacher, a student , or a professional athlete (§7701(b)(3)(D))**

(3) **SPECIAL RULE** : for newly arrived aliens wanting to be considered US residents so as to gain tax benefits

(a) First-year election of residency is available for an alien if the individual is present int eh Us for **31 consecutive days** <u>**AND**</u> AT LEAST 75% of the days in the part of the current year that begins with the first of the 31 consecutive days (§7701(b)(4))

(b) **Note**: the election **CANNOT BE MADE** before the individual meets the substantial presence test for the succeeding year (*i.e.,* the taxpayer either obtains a filing extension for the first year **OR** files and amended return)

(c) If the election CAN BE MADE → it is effective for the portion of the year beginning with the first of the 31 days

b) Corporations

(1) A foreign corporation is taxable under §881 and §882 on

(a) Income effectively connected with the conduct of a trade or business in the US **OR**

(b) On specified US investment income (§7701(a)(5)

(2) **Note:** determination of whether an entity is a *"corporation*" for tax purposes is determined under the "*check-the-box*" regulations

(a) Basic rules

(i) A business entity that is incorporated under US federal or state law is a corporation for US tax purposes

(ii) A business entity formed or created under foreign law is a **corporation** for US purposes **IF** <u>that form of entity is specifically listed in the Regulations</u> (*"per se"* corporations*)*

(iii)**Note**: a business entity not classified as a corporation under (i) or (ii) → can elect its classification as a transparent partnership or a nontransparent corporation for US tax purposes

(iv)**Note**: if a business entity has ***<u>only one owner</u>*** AND elects not to be treated as a corporation → treated as a sole proprietorship (*i.e.,* income of the "tax nothing" will be *deemed* to be earned directly by that owner (Reg. §§301.7701-2 and 3)

4. *Expatriates*

a) If individual = a resident of the US → renunciation has no tax effect because US residents are taxed in the same manner as US citizens

b) if individual is nonresident → income from foreign sources (e.g., interest or dividends from foreign investments) **generally** is not subject to US taxation

c) NOTE: if a citizen gives up US citizenship AND TAX AVOIDANCE WAS ONE OF THE PRINCIPAL PURPOSES → the taxpayer is taxed like a US citizen or resident on income from US sources for a 10-year period if the tax exceeds the tax that would apply to the nonresident under §871

d) **Note:** any tax imposed by §877 is reduced by any income tax imposed by another country on the US source income

(1) §877 also applies to long-term residents who terminate US residency

(a) **definition**: *"long-term resident*" = an individual who is a lawful permanent resident of the US for 8 of the 15 years preceding termination of residency

(b) Note: the requisite tax-avoidance motive to trigger §877 *is presumed* **IF THE INDIVIDUAL MEETS EITHER THE** *NET INCOME OR THE NET WORTH TEST*

(i) Net Income = if the individuals average annual net income tax for the 5 years preceding the expatriation exceeds $100,000

(ii) Net Worth = the individual's net worth equals at least %500,000

(iii)Note: the figures are indexed for inflation

II. Source Rules

A. General Comments

1. *the task here is to determine the source of the income concerned*

2. *general principal = the source rules derive themselves from an attempt to identify the geographic locus of the economic activity or financial arrangements that generated the income*

3. *THE QUESTION IS ALWAYS WHETHER INCOME AND RELATED DEDUCTIONS AND CREDITS DERIVE FROM INSIDE OR OUTSIDE THE us*

B. Sources of Authority

1. *Layout of the Source Rules in the Code : §861 - §865*

a) §861

identifies categories of US-source income

b) §862

identifies categories of foreign-source income

c) §863

deals with categories of income that are partially US=-source and partially foreign-source

d) §864

defines a number of relevant terms and prescribes rules for allocating certain expenses to US and foreign source income

e) §865

establishes elaborate rules for determining the source of income derived from the sale of personal property

2. Where the Code is silent → have been developed by regulation and judicial interpretation OR treaties

C. Income Source Rules

1. important to two groups

a) US citizens, residents and domestic corporations

(1) Because the foreign tax credit is available for income taxes paid to foreign countries to offset US income taxes ONLY IF the foreign taxes are paid with respect to foreign source income

b) Nonresident alien individuals and foreign corporations

(1) Important for 2 reasons

(a) Business income → generally the case that income must be from US sources to be effectively connected income and therefore subject tax under §871(b)(individuals) and §882(corporations) (But see, §864(c)(4))

(b) Non-business income (*i.e.,* FDAP income) → the 30% withholding tax is applicable only to US source income

2. Interest

a) Domestic Payor

(1) General rule = *interest* is sourced by reference to the residence of the payor

(a) In determining the source → the place of payment or the place where the debt is located IS IRRELEVANT

(b) types

(i) Interest paid by a domestic corporation, noncorporate resident of the US, federal government or an agency or instrumentality of the federal government = US source interest

(ii) Note: a domestic partnership is considered a US resident for purposes of the interest rule IF the partnership is engaged in a t/b in the US at any time during the taxable year (Reg. §1.861-2(a)(1))

(2) Exceptions to the general rule

(a) Payment of interest by a foreign branch of a US bank is TREATED AS FOREIGN SOURCE INTEREST EVEN THOUGH THE JURIDICAL PAYOR IS A US BANK (§861(a)(1)(B))

(b) Interest paid by a domestic corporation is treated as foreign source interest IF AT LEAST 80% of the corporations gross income (*computed during the three preceding tax years*) is derived from foreign source t/b income (§861(a)(1)(A) and §861(c)(1))

(i) Note: if this exception applies → none of the interest is treated as US source interest *even though* some of the interest might be attributable to a corporation's US activities

(a) Note: if the interest is paid to a "RELATED PERSON" → a portion of the interest which is attributable to the payor's US gross income for the three-year period is treated as US source income (§861(c)(2) and §954(d)(3))

(i) "*related person*" general refers to any foreign taxpayer owning 10% or more of the voting power of the interest-paying corporation

b) Foreign Payor

(1) General rule

(a) Interest paid by a foreign corporation is FOREIGN SOURCE INCOME under §862(a)(1)

(i) Thus, a foreign lender is not subject to a 30% tax on the receipt of interest paid by a foreign corporation

(ii) Note: if the foreign corporation is engaged in a t/b in the US through a BRANCH → interest paid (or *deemed paid*) by the US branch = traded as if paid by a domestic corporation (§884(f)

(a) Taxable under either §871(a) or §881

(iii)Interest paid by a FOREIGN PARTNERSHIP engaged in a t/b in the US = treated as US source interest and subject to the 30% withholding under §871(a) and §881. Reg. §1.861-2(a)(2))

(iv)Note: *Substitute interest payments*

(a) "*Substitute interest payments*" = payments made by a foreign borrower of securities to the foreign lender

(b) treated as US source income IF the interest accruing on the transferred security would have been US source income (Reg. §1.861-2(a)(7))

3. Dividends

a) Domestic Payor

(1) Dividend paid by a domestic corporation = US source income (§861(a)(2)(A))

(2) US source income received by a nonresident alien or a foreign corporation is subject to 30 tax under (§871(a) or §881)

(3) Note: a dividend <u>PAID BY A US PAYOR</u> is taxable in the US because the US provides the economic environment in which the dividend-paying corporation conducts business (But see, §871(i) and 881(d), supra)

b) Foreign Payor

(1) Paid by a foreign corporation to a foreign shareholder → non US source income & not subject to the 30% tax in the US (§861(a)(2)(B))

(2) Note: if the foreign corporation was engaged in a t/b in the US → portion of any dividend payment may be treated as US source income

(a) If <u>25% OR MORE OF A FOREIGN CORPORATIONS GROSS INCOME FOR THE THREE PRECEDING YEARS IS us BUSINESS INCOME</u> → the portion of the dividend that is attributable to the corporation's US business income is considered US source income

(3) Dividends paid out of US t/b income to foreign shareholders are not subject to the 30% withholding tax IF TH BRANCH PROFITS TAX IS APPLICABLE

(4) Substitute dividend payment

(a) "Substitute dividend payment" = a payment made by a borrower of stock to the lender of stock which is the equivalent to a dividend payment

(b) sourced in the same manner as the dividend payment itself (Reg. §1.861-3(a)(6))

4. *Personal Services*

a) Source rule = compensation for services performed in the US are US source income subject to a de minimis exception

(1) *De minimis* exception = compensation for services performed by a nonresident alien individual temporarily present in the us is foreign source income IF

(a) The individual is not present in the US 90 days during the taxable year; <u>AND</u>

(b) The compensation does not exceed $3,000

(c) Note: <u>payments must be from a foreign employer</u> not engaged in a t/b in the US or the foreign office of a US employer (§861(b)(1))

b) General rule

(1) Nonresident alien performing services in the US is *deemed* to be engaged in a t/b in the US

(a) The compensation is treated as effectively connected income

(b) Taxable under §871(b)

(2) To the extent that the compensation IS FOR SERVICES PERFORMED OUTSIDE THE US → generally not subject to US taxation (Reg. 1.861-4(b))

(3) Note: if a corporation receives income in the form of personal services performed by an employee or agent → the corporation's compensation is <u>sourced in the place where the employee or agent performs the services</u> (See, *Bank of America v. US* (Ct.Cl.1982)

(a) Payments covered by the "*place of performance*" rule include not only direct compensation BUT ALSO fringe benefits, sales commissions, amounts received under a covenant not to compete AND EVEN advertising income (*Comm'r v. Piedras Negras Broadcasting Co.* (5th Cir. 1942))

(b) Issue in some cases = where the services are actually performed

(i) *Stemkowski v. Comm'r* (2ndCir.1982) is on point

(ii) Facts: hockey player is paid $400,000 a year by a US hockey team. That portion of the $400K attributable to the games played in Canada is not taxed in the US because it is foreign source income not effectively connected with the conduct of a US t/b.

(iii)Issue = Should any portion of the $400K be allocable to pre-season activities, to pos-season playoffs, to the off-season?

(iv)Court held that services included pre and post-season but not off-season

c) The Code provides specific source rules for specific types of services income

(a) Ex: ½ of the income from furnishing transportation (*e.g.,* income of a shipping company or airline) is US source income <u>IF</u> the trip begins or ends in the US (§863(c)(2)(A))

(i) if the trip begins and ends in the US → all the income is from US sources *even if* some part of the trip is over international waters or a foreign country

(ii) Note: a round trip is treated as two trips (an outbound and an inbound)

(a) Note: this source rule does not apply to salaries and wages of transportation employees

(b) Ex: International communications income of a US taxpayer is treated as 50% from foreign sources (§863(e)(1)(A)

(i) International communications income of a foreign taxpayer = usually treated as foreign source income UNLESS the income is attributable to a US office or other fixed place of business

(ii) Note: income from communications between two points in the US is US source income *EVEN IF ROUTED* through a satellite

5. *Rentals and Royalties*

a) Royalties from the lease of TANGIBLE PROPERTY are sourced where the property is located (§861(a)(4) and §862(a)(4))

b) Royalties from the license of INTANGIBLE PROPERTY including patents, copyrights, goodwill or other intellectual property are sourced according to where the intangibles are used (§861(a)(4) and §862(a)(4))

(1) Note: if the intellectual property is SOLD OUTRIGHT rather than licensed, BUT THE SALES PROCEEDS ARE CONTINGENT ON THE PRODUCTIVITY, USE, OR DISPOSITION OF THE INTANGIBLE BY THE PURCHASER → source of the sales proceeds is determined as if such payments are royalties (§865(d))

(2) Note: SDI Netherlands B.V. v. Comm'r

(a) Rejected the *cascading royalty approach*, ruling that the payment from a Dutch licensee (sublicensor) to the Bermudan licensor was not US source income even to the extent the payment is attributable to royalties received by the sublicensor from a US sublicense exploiting the US intangible rights

(3) Note: The Regulations attempt to distinguish the copyright from the copyrighted article

(a) a copyright includes

(i) The right to make copies of a computer program for distribution to the public

(ii) The right to prepare derivative works

(iii)The right to make a public performance OR the right to publicly display the program (Reg.§1.861-18(c)(2))

(b) One you make this determination (whether an article or a copyright has been transferred) →issue is whether the entire copyright or article has been transferred OR whether there has been a lease or license

6. *Real Property*

a) Gain or loss from the disposition of US real property or stock of a US RPHC (see §897(c)) is US source income

b) Gain from the sale of real property located outside the US is foreign source income

7. *Personal Property*

a) "personal property" essentially includes all property (tangible and intangible) that is not real property

b) Purchased Inventory

(1) Gain from sale of purchased inventory = sourced where the sale takes place - - generally, where title passes (§865(b) and §861(a)(6))

(2) Note: the *title passage rule* for purchased inventory allows taxpayers great latitude

(a) Game = if you can arrange for title to pass abroad so that any foreign taxes on the inventory might be creditable against US taxes (*see, Liggett Group Inc. v. Comm'r*)

(b) Nonresident aliens and foreign corporations selling inventory for use in the US may be able to arrange for title to pass abroad in order to avoid US tax IF the gain is not attributable to a US office or other fixed place of business (§864(c)(4))

(3) Limits to the title-passage manipulation

(a) If the transaction is structured with the primary purpose of tax avoidance → the title-passage rule *may not apply*

(i) Instead = the location of negotiations; execution of the agreement; the location of the property itself; location of the payment itself *may control* (Reg. §1.861-7(c))

(b) If a nonresident maintains an office or other fixed place of business in the US → income from the sale of inventory (and other personal property) attributable to such place of business <u>is sourced in the US</u>

<u>REGARDLESS OF WHERE TITLE PASSES</u> (§865(e)(2)(A))

(c) Note: if inventory is *sold outside the US* <u>AND</u> A FOREIGN FIXED PLANCE OF BUSINESS MATERIALLY PARTICIPATES IN THE SALE → sale is treated as foreign source income (§865(e)(2)(B))

c) Produced Personal Property

(1) The title-passage rule <u>DOES NOT APPLY</u> to inventory (or other personal property) that is not purchased by a taxpayer <u>BUT INSTEAD</u> is <u>produced by the taxpayer</u>

(a) Income from the sale of such property is <u>allocated</u> for source purposes between the country of production and the country of sale (§865(b) and §863(b)(2))

(b) Both the country of production and country of sales contributes to the value of the produced inventory

(2) Analytical steps

(a) Determine where the income is sourced (using principles stated above) under §863(b)

(b) Taxation then depends on whether the income is effectively connected income under either §864(c)(3) <u>OR</u> §863(c)(4)

(3) Regulation specify a 3-step analysis for manufactured inventory

(a) Gross income is allocated to the sales activity and the production activity under one of the specified methods

(i) The Regulations use the <u>"*50/50 method*"</u> as the default

(a) 50% of the gross income is considered attributable to the sales activity and the other 50% is considered attributable to the production

(b) once the allocation has been made under the 50/50 method → the income allocated to production is sourced <u>based on where the production assets are located</u>

(i) *"production assets"* = tangible and intangible assets that are directly used to produce inventory

(ii) taxpayer <u>may elect</u> to use the *independent factory price* (IFP) method <u>IF</u> an IFP can be fairly established

(b) Gross income allocated to the sales activity and the production activity is then sourced

(i) Sales activity gross income is sourced based on the title passage rule (§861(a)(6))

(ii) The production activity gross income is sourced according to the relative domestic and foreign production assets

(c) The expenses are allocated in accordance with the Regulations (Reg. §1.863-3)

d) Intangible Property

(1) Sourced 2 ways

(a) Method 1: If the sales proceeds are <u>contingent on the productivity, use or disposition of the intangible</u> → any gain is sourced *as if* the payments received were royalties (*i.e.,* source is determined by where the property is used) (§865(d))

(b) Method 2: if the sales proceeds <u>not contingent</u> on the use of the intangible → any gain is sourced by reference to the residence of the seller (§865(a) and §865(g))

(2) Note: <u>SPECIAL RULE FOR GOODWILL</u>

(a) Noncontingent payments received for the transfer of goodwill are <u>sourced in the country where the goodwill was generated</u> (§865(d)(3))

e) Depreciable Property

(1) 2 Rules

(a) To the extent that any previous depreciation deductions reduced US source income → the depreciation adjustments are treated as US source income <u>REGARDLESS OF THE RESIDENCE OF THE OWNER OR THE PLACE WHERE TITLE PASSES</u>

(b) To the extent that previously taken depreciation deductions were taken against foreign source income → the depreciation adjustments are treated as foreign source income

(c) Note: any other gain (*e.g.,* capital appreciation) is sourced like gains from inventory by determining where title passes (§865(c)(2))

f) Other Personal Property

(1) General rule = ***residence of the seller rule***

(a) Sale of nondepreciable personal property (*e.g.,* stock) by a US resident = US source

(i) EXCEPTION -Note: if the US resident maintains an office or other fixed place of business outside the US→ income from the sale attributable to that office <u>is treated as foreign source income IF</u> the foreign country imposes at least a 10% tax on income from such sale (§865(e))

(b) Sale of nondepreciable personal property (*e.g.,* stock) by a nonresident = any gain produces foreign source income

(c) EXCEPTION 2 for sale of stock under the ***residence of the seller rule***

(i) If a US resident sells stock of a foreign affiliate (defined in §1504) in a foreign country where the affiliate derived more than 50% of its gross income from an active t/b during the preceding three (3) years →any gain is foreign source income (§865(f))

(a) Note: even if a US resident sells stock of a foreign corporation that is not a foreign affiliate → any gain is foreign source income IF a treaty between the purchaser's country and the US so provides AND taxpayer chooses the benefits of the treaty (§865(h)

(b) Note: consequences

(i) Treating any gains a foreign source income means that any foreign taxes imposed on that gain are creditable against US tax liability

(ii) Foreign taxes imposed on <u>US source income</u> are <u>not creditable</u> against US taxes on that income

(2) General rule of §865(a) (which applies to nondepreciable personal property) is essentially a <u>residual rule - - although it does apply</u> to

(a) Sales of stock and securities

(b) To sale of intangibles <u>where the sales proceeds ARE NOT contingent on the use of the intangible</u>

g) Sales Through Offices or Fixed Places of Business in the United States

(1) Regardless of the rules previously stated → if a nonresident maintains and office or other fixed place of business in the US <u>to which gain from sale is attributable</u>→ gain is <u>US source income</u> (§865(e)(2)(A))

(a) Note: EXCEPTION FOR INVENTORY SOLD FOR USE OUTSIDE THE US THROUGH A FOREIGN FIXED PLACE OF BUSINESS THAT MATERIALLY PARTICIPATED IN THE SALE (§865(e)(2)(B))

h) Other Gross Income

(1) Scholarships, fellowship grants, prizes and awards are considered to be FDAP income subject to the 30% withholding <u>IF</u>

(a) They are from US sources; <u>AND</u>

(b) If the payment is included in gross income (*e.g.*, a prize or scholarship that does not satisfy the requirements of §117) (Reg. §1.871-7(a)(2) and Reg. §1.1441-2)

(c) Note: the source of a payment made to a nonresident as a scholarship <u>is the country of residence of the person making the payment</u> (Reg. §1.863-1(d)(2))

(i) Note: if a nonresident conducts activities outside the US → the scholarship has a foreign source <u>regardless of the residence of the payor</u>

(2) *"notational principal contract"*

(a) defined = a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specific rate on a notational principal amount in exchange for specified consideration

(b) general rule = income is sourced in the country of the recipient's residence (see Reg. §1.863-7(a)

i) Residence for Source Rule Purposes

(1) *"residence"*

(a) definition for source purposes is different that that under §7701(b)

(b) "*<u>NONRESIDENT</u>*" = a US citizen or resident alien (§7701(b)) who does not have a "tax home" in the US (see, Reg. 1.911-2(b) and §162(a)(2))

(c) "<u>RESIDENT</u>" = a nonresident alien who has a tax home in the US is a resident for purposes of the source rule under §865

(2) *"tax home*" = located at the taxpayer's regular or principal place of business

D. Deduction Allocation Rules

1. Generally

a) Two different tax treatments

(1) 30 tax on FDAP of a nonresident is imposed on gross income → <u>no deductions are allowed</u>

(2) income that is effectively connected with the conduct of a t/b = imposed on taxable income (§861(b), §871(b), §882, §873)

(a) deductions are permitted

(b) THE GAME = to the extent that expenses are allocated to income effectively connected to the conduct of a t/b a foreign taxpayer's income subject to US tax <u>decreases</u>

(c) Note: allocation of deduction also important to US residents and citizens doing business or investing abroad

(i) Such taxpayers are taxable on their worldwide income → all deductible expenses reduce their US tax liability; <u>AND</u>

(ii) Such taxpayers can offset their US tax liability with foreign income taxes paid on their foreign source taxable income <u>IF</u> those foreign taxes do not exceed the US taxes potentially imposed on that income

b) Note: to the extent that the expenses are allocated to foreign source income → US taxpayer may have a smaller foreign tax credit

(1) Bottom line = US taxpayers generally prefer expenses to be allocated against US source income

c) Code does not specify an allocation method

d) Generally = taxpayers must

(1) Allocate deductions to a class of gross income; and then (if required)

(2) Apportion deductions within the class of gross income between the statutory grouping and the residual group (Reg. §1.861-8(a)(2))

(3) Note: for US taxpayers the allocation and apportionment process is necessary to determine the foreign tax credit (see, *infra*)

2. Interest

a) US Corporations

(1) Several methods

(a) Direct = some interest is directly allocated to a specific class of income <u>IF</u>

(i) the loan proceeds are applied to purchase and improve real property; <u>OR</u>

(ii) depreciable personal property <u>AND</u> the creditor can look only to the identified property for security (Reg. §1.861-10T(b))

(b) apportionment: if money is borrowed for general business purposes → the interest paid is apportioned under §864(e) between US and foreign sources according to basis of all of the taxpayer's assets

(i) Note: for purposes of this apportionment <u>the assets of all affiliated corporations are taken into account</u> (§1504)

(ii) Method of allocation is premised on the notion that money is fungible making it difficult to trace accurately interest expenses to a particular item of income

(2) *Netting Rule*

(a) Counters tax avoidance by allocating a US taxpayer's interest deduction to any interest received from a foreign subsidiary (Reg. §1.861-10(e))

(b) The rule is triggered if

(i) The amount of related group indebtedness (*i.e.,* borrowing among related corporations) increases compared to the amount of indebtedness for a 5 year testing period (Reg. §1.861-10(e)(2); <u>AND</u>

(ii) If the amount of excess US shareholder indebtedness (*i.e.,* borrowing from unrelated lenders by US members of the corporate group) increases compared to the amount of indebtedness for a 5-year testing period (Reg. §1.861-10(e)(3)

(iii)Bottom line = for a given year the *netting rule* may apply <u>IF</u> there is <u>BOTH</u> an increase in borrowing by a US parent corporation from unrelated lenders <u>AND</u> an increase in indebtedness owed by a foreign subsidiary to the US parent

b) Foreign Corporations

(1) Allocation rules are found under Reg. §1.882-5

(a) Generally have the effect of allocating a larger interest deduction to US source income than the asset allocation method of Reg. §1.861-8

(b) Three (3)-step process

(i) First = determines the value of US assets that generate US effectively connected income

(ii) Second = determines its US connected liabilities by multiplying its US assets by a special fixed ratio of 50% (93% for a bank) or by the actual ratio of worldwide liabilities to worldwide assets

(iii)Third = determines the interest allocable to the US connected liabilities under the adjusted US-booked liabilities

method (ABLM) <u>OR</u> the separate currency pools method (SCPM)

(a) Note: SCPM is more sensitive to currency fluctuations

(c) NOTE: <u>the application of Reg/ §11.882-5 has bee held to violate commitments under the treaty between the US and the United Kingdom and likely violates commitments under other treaties as well</u> (see, *National Westminster Bank, PLC v. United States* (Fed.Cl.1999)

3. *Research and Experimental Expenditures*

a) §864(f) - - taxpayers are required to allocate research and experimentation expenses <u>undertaken solely to meet legal requirements imposed by a government</u> to the jurisdiction of that government (assuming the expenditures are not expected to generate income outside the jurisdiction

b) Note: after accounting for such legal requirements → the taxpayer is required to allocation the remaining expenses <u>EITHER using</u>

(1) The sales income method

(a) 50% of the deduction for research and experimentation shall be apportion exclusively to the geographic location where the activities accounting for more than half the deduction were performed

(b) the remainder is apportion on the basis of where the sales resulting from the research take place (Reg. §1.861-17)

(2) Gross receipts method (Reg. §1.861-17(b)(1)(ii)

(a) 25% of any US deduction for R&E is apportioned exclusively to the geographic location where the activities accounting for more than half of the deduction were performed

(b) remainder is apportioned on the basis of gross income <u>so long as</u> *the result of the apportionment is at least 50% of the result under the sales method*

4. *Losses*

a) The source of loss is important for determining the foreign tax credit

b) General rules

(1) If income from the activity that produced the lass would have been foreign source → the loss generally will be allocated and apportioned against foreign source income (§865(j); Reg. §1.865-1)

(2) Sale of stock is sourced in the same manner as gain (*i.e.,* residence of the seller) ignoring whether the stock sold is stock of an affiliate (§865(f)) or would have been treated as foreign source dividend if sold at a gain (§1248) (Reg. 1.865-2)

(a) Note: if the stock sale is attributable to an office or other fixed place of business in a foreign country → the loss is allocated against foreign source income <u>IF</u> a gain on the sale would have been taxable by the foreign country at a 10% or greater rate (Reg. §1.865-2(a)(2))

(b) Note: loss on the sale of stock in a foreign corporation is allocated against foreign source income to the extent that dividends paid during the previous 24 months were treated as foreign source income (Reg. §1.865-2(b)(1))

(c)

III. US Activities of Foreign Taxpayers

A. General

1. *nonresident's income usually falls into one of two regimes*

a) §871(b) (for individuals) §882 (corporations)

(1) income for nonresidents "*engaged in a trade or business*" in the US → net income "*effectively connected*" with the conduct of the t/b is taxed in same manner as net income earned by us residents

b) §871(a) (individuals) §881 (corporations)

(1) Fixed or Determinable Annual or Periodical (**FDAP**) gains, profits and income (basically investment income) from US sources earned by nonresidents is typically taxed on a gross basis at a flat rate of 30% (or lower treaty rate)

B. "Engaged in a Trade or Business" in the US

1. *threshold for business activities to constitute a t/b is* ***low***

a) Service has taken the position that a foreign taxpayer present in the US to demonstrate its product and solicit orders was engaged in a t/b in the US EVEN IN THE ABSENSE OF A US OFFICE (Rev.Rul. 56-165

b) Personal services

(1) a single performance by a visiting entertainer or athlete in the US constitutes a US t/b (Rev.Rul 70-543

(2) exception = *de minimus*

(a) will not constitute a t/b if:

(i) the services are performed while the taxpayer is temporarily present in the US

(ii) the taxpayer is present in the US for nor more than **90 days** during the taxable year

(iii)the compensation for the services in the US **does not exceed $3,000**

(iv)the employer is not engaged in a trade or business in the US or a foreign office of a US person

(b) NOTE: treaties frequently broaden this *devminimis* rule

c) partnerships

(1) partners considered to be engage in t/b if the partnership is engaged in t/b in the US

C. "Effectively Connected" Income

1. issue = whether US and foreign source income from a current t/b is effectively connected income

a) US Source Income

(1) "effectively connected " is defined in §864(c)

(2) US source investment income is "effectively connected" if (§864(c)(2):

(a) The income is derived from assets used in the conduct of the US trade or business (the asset test)

(i) Test satisfied if the taxpayer receives interest from an account receivable arising the t/b

(b) The activities of the trade or business are a material factor in the realization of the income (the "business activities test")

(i) Test determines if dividends derived by dealers in securities or royalties derived from a patent licensing business or service fees derived from a servicing business are considered effectively connected income (§1.864-4(c)(3))

b) Foreign Source Income

(1) Generally foreign source income <u>is not</u> treated as "effectively connected" income & not taxable in the US (§864(c)(4)(A))

(2) Exceptions

(a) "ATTRIBUTABLE TO" a US "office or fixed place of business

(b) RENTS OR ROYALTIES from intangible property located or used outside the US which are derived in the active conduct of a US t/b is effectively connected income (§864(c)(4)(B)(i)

(c) DIVIDENDS OR INTEREST from stock or securities derived from a US t/b by banks or other financial institutions OR by a corporation whose principal business is trading stock or securities for its own account are effectively connected income (§864(c)(4)(B)(ii))

(d) SALE OF INVENTORY - - any foreign source gain from the inventory sale is treated as effectively connected income which is taxable in the US (§864(c)(4)(B)(iii))

(i) Treated as effectively connected IF it is attributable to an "office or other fixed place of business" in the US

(a) "attributable to" if

(i) office is a material factor in the production of income; **AND**

(ii) the income is realized in the ordinary course of the trade or business of the office (see specifically, §865(c)(5)(B))

(iii) ex: an office would be considered a material factor in the production of income if it participated in soliciting an order, negotiating a contract, or performing other significant services for the consummation of the sale (Reg. §1.864-6(b)(2))

(b) Generally a foreign taxpayer is ***DEEMED*** to have an "office or other fixed place of business" in the US if it has a **store or plant or an office where the taxpayer engages in a trade or business** (Reg. §1.864-7)

(c) Note: an office or fixed place of business of an agent does not satisfy this requirement UNLESS

(i) the agent possesses and regularly exercises the authority to negotiate and conclude contracts for the principal **OR** maintains a stock of merchandise from which he regularly fills orders on behalf of the principal; **AND**

(ii) is not an <u>independent agent</u> (see §864(c)(5)(A))

(ii) Exception = if a foreign office of the taxpayer materially participates in the sale AND the inventory is <u>not used in the US</u>→ **gain is not considered effectively connected**

(a) Note: the newer source rule in §865(e)(2) has made §864(c)(4)(B)(iii) largely irrelevant

2. *Income Effectively Connected to a pre-existing t/b*

a) Fact situation = what if the foreign taxpayer in the last year of conducting a trade or business in the US sells its inventory or performs services <u>on the installment method</u>?

(1) §864(c)(6) = if the income would have been effectively connected income in the year of sale (or performance, in the case of services) had the entire purchase price been received → the income will be effectively connected income even if received after the year of sale

(2) related abusive transaction = foreign taxpayer ceases to conduct a t/b in the US and then disposes of the property used in that trade or business

(a) had the property been sold while the taxpayer was engaged in t/b → would have been effectively connected

(b) BUT! Under §864(c)(7) property that is business property retains its character FOR TEN YEARS AFTER BUSINESS USE CEASES → any gain from its sale will be effectively connected income

3. *Effectively Connected Income Election*

a) There are times where a foreign taxpayer <u>may prefer</u> to have income treated as if it were effectively connected **even where it is not**

b) Election = the “net basis” election

(1) Permits nonresident alien individuals and foreign corporations that own US real property can elect to treat the rental income as effectively connected income (§871(d) and §882(d)

(2) allows a holder of US real property the benefit of business deductions such as depreciation rather than being taxed at a flat 30% rate on gross rental income

(a) why? = in some cases a higher nominal tax rate applied to net income is more favorable to a taxpayer than a lower rate applied to gross income

D. Nonbusiness Income from US sources

1. under §871(a) and §881(a) nonresident aliens and foreign corporations are subject to a 30% (or lower treaty rate) on several types of nonbusiness income

a) tax imposed at a flat 30% rate without any deductions or other allowances for costs incurred in producing the income

b) tax is typically collected through withholding

c) tax applies to interest, dividends, rents, royalties, other "fixed or determinable annual or periodical" income (FDAP) **IF**

(1) the income is includable in gross income; **AND**

(2) the income is from US sources;**AND**

(3) the income is not effectively connected with the conduct of a US trade or business

d) **Note**: <u>actual payment is not necessarily a prerequisite to taxation of FDAP income</u> (see, Central de Gas de Chihuahua, S.A. v. Comm'r (Tax.Ct. 1994)(US source rental income reallocated from a related corporation was subject to tax under §881 even though no actual payment was received)

e) Decision to tax FDAP income on a gross basis is more a concession to economic reality than it is a policy decision → a nonresident alien may escape US tax jurisdiction if no withholding tax is collected before payment is received

f) Categories of FDAP income

(1) Interest

(a) "interest" - - includes bother OID as well as unstated interest (HINT: the portion of a deferred payment under a contract of sale that is treated as interest)

(b) NOTE: most interest received by nonresident aliens is not subject to the 30% tax <u>because of the "portfolio interest" exception</u> (*see, infra*)

(i) OID

(a) OID obligation is where the face value exceeds the issue price

(b) The §1237 OID rule does not apply to short term OID instruments (§871(g)(1)(B)

(c) OID is treated as if interest payments were actually paid by the borrower to the lender which in turn are loaned back to the borrower

(i) BUT! The OID accrued by a nonresident lender is not subject to the 30% tax on investment income UNTIL the debt instrument is sold, exchanged or retired (§871(a)(1)(C) and §881(a)(3))

(ii) Portfolio Interest

(a) US source interest received by a nonresident is not subject to a 20% tax if the interest paid is "portfolio interest" (§871(h) and §881(c)

(b) Purpose of exemption = allow US borrowers to compete for loans with borrowers from other countries which often do not tax interest payments made to foreign lenders

(c) In enacting the exemption → Congress sought to restrict its benefits to the intended beneficiaries (ie US borrowers and unrelated foreign lenders) rather than unintended beneficiaries such as foreign lenders related to the US borrower or any US lender (or subsequent purchasers of the debt instrument)

(i) **<u>Anti-related foreign lender protection</u>** =Thus , the exemption **does not apply** to interest payments made to a foreign lender who owns (directly or indirectly) 10% or more of the voting power of the stock of the borrower (§871(h)(3)

(ii) **<u>Anti-US lender protection</u>** = generally interest paid on bearer debt (i.e. an unrecorded debt instrument entitling the holder to interest and principal payments) is portfolio interest **<u>only</u>** if the debt: 1. is sold under procedures designed to prevent sale of the debt to US persons; 2. bears interest payable outside the US; and, 3. indicates that the US holders are subject to tax penalties (§871(h)(2)(A)) and §163(f)(2)(B)

(iii) interest paid on registered obligations qualifies under the exemption **<u>if</u>** the issuer obtains a statement that the beneficial owner is not a use person (§871(h)(2)(B))

(d) **Note:** because portfolio interest can escape US withholding **but dividends on US corporations are subject to a 30% gross base withholding tax** → foreign investors might seek to disguise a dividend payment as an interest payment

(i) **Anti-abuse provision →** §871(h)(4) denies the portfolio interest exemption for any interest determined by reference to the receipts, sales, income or asset appreciation of the debtor (**or related person**)

(ii) Note: if the interest rate is tied to the dividend rate of the payor → the portfolio interest exemption is **<u>not available</u>**

(iii)**Note:** multiparty financing regulations under §7701(l)

(a) Purpose = prevent foreign taxpayers from using intermediate entities to obtain the unintended benefit of reduced withholding

(b) IRS assumes authority to disregard, for purposes of §881, the participation of one or more intermediate entities in a "*financing arrangement*" where such entities are acting as *"conduit entities"* (Reg. §1.881-3)

(i) "*financing arrangement*" = series of two or more financing transactions (e.g. lending money, purchasing stock, leasing or licensing property), whereby one party (financing entity) loans money or other property through one or more parties (intermediate entities) to another party (financed entity)

(ii) "*conduit entity*" = an intermediate entity will meet qualify as a *"conduit entity"* if:

(iii) the participation of the intermediate entity in the financing arrangement must reduce the tax imposed by Code §881

(iv) the participation of the intermediate entity is pursuant to a tax avoidance plan

(v) the intermediate entity is either 1. related to the financing entity or the financed entity; or, 2. unrelated, but "would not have participated in the financing arrangement on substantially the same terms **but for** the fact that the financing entity engaged in the financing transaction with the intermediate entity

(vi) **Note**: if a financing arrangement is found to be conduit financing arrangement → payments from the financed entity to the intermediate entity will be recharacterized as if the payments were made directly to the financing entity

(iv) Bank Deposits

(a) Interest earned by a nonresident investor on US bank deposits **<u>is not</u>** subject to the 30% tax on FDAP (§871(i) and §881(d))

(b) **Note**: deposit interest that is effectively connected with the conduct of as US t/b is taxable as business income

(v) Interest Substitutes

(a) The regulations clarify that the substitute interest payments will have the same character as the underlying interest payment **and** will be subject to §882 whether borrower is a US citizen or foreign borrower (Reg. §1.881-7(b))

(vi) Dividends

(a) From US sources are generally subject to the 30% withholding

(b) Exceptions

(i) Where at least 80% of a dividend-paying domestic corporation's gross income is derived fro foreign source business income for the preceding three years → dividend paid is **not subject to the 30% withholding tax** to the extent that the dividend is attributable to the foreign income (§871(i)) - - <u>rule recognizes that the US contributed little to the economic environment that made the dividend possible and therefore lacks the territorial jurisdiction</u>

(ii) Where the dividend paid by a foreign corporation **with substantial US earning** (treated as US source income) often th e30% withholding tax does not apply because of the operation of the branch profits tax (see, *infra*)

(c) **Note:** substitute dividend payments - - where a foreign owner of stock lends the stock to a person and receives a substitute payment equivalent to a dividend distribution on the loaned stock

(i) Treated as FDAP income in the same manner as an actual dividend (Reg. §1.871-7(b)(2) and 1.881-2(b)(2))

(ii) If the actual dividend paid to a foreign stock borrower (or purchaser in repo) is subject to US FDAP taxation → the tax on foreign-to-foreign substitute dividend is equal to the tax that would have been imposed if the dividend was paid directly to the lender (repo seller) minus any US tax paid by the borrower (repo purchaser)

(vii) Rents

(a) Rental income received by a nonresident is subject to the 30% withholding tax **IF** the activities of the nonresident (or agent) in managing the property **do not** constitute a t/b

(b) If they do constitute a t/b → taxed as business income

(viii) Income from Services

(a) Salaries and wages are always treated as FDAP **but are ALMOST NEVER subject to the 30% tax**

(b) Taxpayer's rendering services are considered engaged in a t/b and income taxed as effectively connected income

(ix) Other FDAP

(a) Royalty payments are subject to the 30% withholding **IF** the royalty income is not effectively connected with the conduct of a US t/b (Reg. §1.871-7(b))

(b) Taxable whether received in installments or in a lump sum

(c) Gain from sale of royalty-producing property is treated as a royalty if payments are contingent on the property's productivity, use or disposition (§871(a)(1)(D)

(d) See also ALIMONY, COMMISSIONS, AND PRIZES AND GAMBLING WINNINGS

(x) Capital Gains

(a) Received from the sale of property are **almost never** subject to the 30% withholding tax

(b) Gains from sale of property that is effectively connected **OR** is deemed to be effectively connected with the conduct of a US trade or business are taxable as business income

(c) Individual who is present in the US for 183 days or more during the taxable year will be considered a US resident taxable on worldwide income (*including capital gains*) so §871(A)(2) will not apply (see §7701(b))

(i) **Note**: it is possible for the person to fail the 183-day test under §7701(b) AND YET satisfy the 183-day test under §871(a)(2) which does not refer to the method of counting days under §7701(b).

(ii) **Note**: even in such a case, §871(a)(2) wouldn't apply **unless** the income were US source income

E. The Branch Profits Tax

1. found in §884

2. purpose = to subject the income earned by foreign corporations operating in the US to two levels of taxation like income earned and distributed by US corporations operating in the US

3. taxing regime

a) foreign corporation

(1) income is taxed at the maximum marginal rate of 35% when it is earned **AND**

(2) an additional 30% branch profits tax is imposed when the income is repatriated from the US branch to the foreign home office by the foreign corporation (or *deemed* to be repatriated because it is not reinvested in "US assets")

(a) the 30% branch profits tax is levied on the "*dividend equivalent amount*" in lieu of a secondary withholding tax on dividends paid by the foreign corporation to its shareholders (§884(e)(3)

(b) *"dividend equivalent amount*" = the foreign corporation's earnings and profits that are effectively connected with the conduct of a t/b in the Us subject to certain specified adjustments (§884(b)

(i) **Note**: to the extent that effectively connected earnings and profits are invested in qualifying US assets → *dividend equivalent amount is decreased*

(a) Effect = the base to which the branch profits tax applies is thus decreased because the branch is deemed not to have repatriated the earnings to the corporation's home country

(ii) **Note**: to the extent that a foreign corporation's investment in qualifying US assets ***decreases*** (because of actual repatriation of assets **OR** because US property of the branch which preciously was invested in qualifying US assets is **converted into other nonqualifying assets**) → the dividend equivalent amount increases

(a) The increase reflects the fact that earnings of a previous year are being repatriated or are being treated as having been repatriated

(iii)**Definition**: *"qualifying US assets*" consist of money and property used by the foreign corporation to conduct a t/b in the US (§884(c)(2))

(3) **in effect =** treats the US branch *as if* it were a US subsidiary of the foreign corporation

b) The branch profits tax on interest

(1) The code imposes a 30% tax on interest paid (or deemed paid) by a branch of a foreign corporation engaged in a US t/b

(a) **Note**: in the absence of §884(f) it would be possible for a foreign corporation to decrease or even avoid the branch profits tax **by making interest payments to its foreign investors**

(2) To the extent that deductible interest payments are allocable to the branch's earnings → the interest payments would decrease taxable income, effectively connected earnings and profits **AND** ultimately the dividend equivalent amount on which the branch profits tax is based

(3) Two basic rules for interest paid by the US branch of a foreign corporation

(a) §844(f)(1)(A) = a foreign corporation engaged in a us t/b → interest paid by the US t/b is treated *as if* paid by a domestic corporation

(i) consequence = under §861(a)(1) the interest is US source income generally subject to a flat 30% tax under §871(a) or §881

(b) if it qualifies as **portfolio interest** → there is NO US TAXATION

(c) §844(f)(1)(B) = to the extent that the amount of interest allowable as a deduction under §882 in computing taxable income of the US branch *exceeds* the interest actually paid by the branch → the excess shall be treated as interest paid **by a fictional US subsidiary (the branch) to the parent**

(i) consequence = subjecting the notional interest payment to a 30% tax under §881

(ii) **Note**: the portfolio interest exemption **will not apply** to this excess because it is *deemed* to be paid to a related party (*i.e.,* the home office) (§871(h)(3))

c) The Branch Profits Tax and Secondary Withholding on Dividends

(1) Foreign corp with a US branch is subject to the regular US corp income tax under §882 on income effectively connected with a US t/b

(a) Such income is **also** subject to the branch profits tax to the extent the income is not reinvested in qualifying US assets, as defined in §884(c)(2)

(b) Branch profits tax on US earnings and profits intended to serve the same function as the normal 30% tax on dividend distributions from domestic corporations to foreign investors

(2) Congress preserved a 30% tax on dividend distributions from foreign corporations where the branch profits tax is inapplicable because of an INCOME TAX TREATY which a non-treaty shopping foreign corporation can benefit prohibits the application of the branch profits tax BUT ALLOWS IMPOSITION OF THE 30% TAX ON DIVIDENDS PAID BY A FOREIGN CORPORATION

(a) Essentially = a back-up tax for the branch profits tax (§884(e)(3))

d) Foreign Investment in US Real Property

(1) Operational Income

(a) Example = US property produces rental income for foreign investor

(i) If the foreign investor is considered to be engaged in a US t/b → net rental income (gross rental income minus deductions for depreciation, maintenance, mortgage interest etc.) is effectively connected taxable income under §871(b) or §882

(ii) If foreign investor is not engaged in a US t/b → the gross rental income is taxed at a 30% rate under §871(a) or 881

(a) **Note**: the "*Net Basis" Election*

(i) under §871(d) or §881(d) such a foreign investor may

ELECT to treat the rental income as effectively connected income with can be offset by any appropriate deductions before applying the tax rates under §1 or §11.

(ii) The **election is irrevocable**

(iii)**Note**: normally the foreign investor prefers the offsetting deductions, including depreciation, compared with a tax on gross income

(b) Rev.Rul. 91-7 = the IRS ruled that a nonresident may not make a *net basis* election with respect to US real property for a taxable year in which the taxpayer does not derive any income from such property

(c) Rev.Rul. 92-74 = the IRS ruled that the excess of deductions attributable to US real property over income from the property can be used to offset income from the conduct of a US t/b **AND**, if necessary, may be carried back or forward to other years as a net operating loss

(i) Ruling applies to a foreign corporation **ONLY** but logically should be extended to nonresident aliens as well

(2) Dispositional Income

(a) Income from the sale of US real property by a nonresident engaged in a t/b of buying and selling real property =is treated as effectively connected income taxable in the US *even in* ***the absence of a special provision***

(b) §897 (the Foreign Investment in Real Property Tax Act or **FIRPTA)**

(i) treats the gain from the sale of "*US real property interests*" **as if** the taxpayer is engaged in a trade or business in the US

(a) **AND** AS IF the gain is effectively connected income (§897(a))

(b) Property interest can include fee interests, leaseholds, options and natural resources

(ii) What is "*real property*"?

(a) An equity interst in a US corporation is a "*US real property interest"*(USRPI) → subject to §897 if the corporation is a "*US real property holding corp*" (USRPHC) (§897(c)(2)

(i) **Note**: there is an exception for **<u>stock of a US corporation which is regularly traded on an established securities market</u>**

(ii) <u>Definition</u>: a US corporation is a USRPHC **<u>IF AT ANY TIME</u>** during the previous 5 year the fmv of the corporation's USRPI equaled at least 50% of the sum of the fmv of the corporation's total worldwide real property interests **plus business assets**

(iii) Consequence = disposition by a nonresident of any interest (*other than that of a creditor*) at a gain is subject to US taxation (§897(a))

(iv) **Note**: hybrid securities as well as stock interest are covered

(v) **Dispositions other than sales can trigger us taxation**

(vi) **Note**: §897(e) overrides all statutory nonrecognition provisions unless the property received in the transaction would be taxable in the US if sold

(vii) Definition: a domestic corporation is a USRPHC during the 5 year test period **IF**

(viii) It is a USRPHC on any "*determination date*" (generally: (a) the last day of a corporations tax year and (b) the date of each transaction that might cause a corporation to become a USRPHC - - transactions such as acquisition of a USRPI or the disposition of foreign real property or assets used in a trade or business)(Reg. §1.897-2(c))

(ix)

(iii)The Code "*looks through*" the entity and attributes the sale by the entity to the participants **OR** treats the sale of the entity interest partially as a sale of the US real property held by the entity

(a) The "*look through*" paradigm **DOES NOT APPLY** to a corporate entity which instead is treated like a separate taxpaying entity

(i) Sale by a foreign corporation of US real property is not attributed to the shareholder →→ the foreign corporation is taxed on any gain *as if* the gain were effectively connected income (§897)

(ii) **Note**: b/c the foreign corp is taxed on gain from the sale of US real property under §897 → a foreign shareholder who sells appreciated stock in the foreign corporation is normally not taxable on the sale

(b) Rule applies to determine whether a US corporation is a US real property holding corporation

(i) If the US corporation owns an interest in a transparent entity (*e.g.,* a partnership) or at least 50% (by value) of the stock of a US or foreign corporation → a pro rata portion of the entity's assets is considered owned by the parent corporation (§897(c)(5))

e) Transportation Income

(1) US source income of a nonresident from air or water transportation activities **OR** from leasing or hiring out a vessel or aircraft → the income is subject to US tax **UNLESS** exempted under a reciprocal exemption (§887)

(2) Income treated as effectively connected **IF**

(a) The taxpayer carries on a t/b in the US through a fixed place of business; **AND**

(b) Substantially all the taxpayer's US transportation income is attributable to regularly scheduled transportation

(c) **Note**: if a nonresident has US source transportation income **that is not treated as effectively connected income** → the Code imposes a 4% gross income tax on the transportation income

(3) Income of a nonresident from operation of ships or aircraft = EXEMPTED FROM US TAXATION **IF**

(a) An equivalent exemption is provided for US citizens and residents by the country in which the taxpayer resides (§872(b)(1))

(i) **ANTI-FLAG SHOPPING PROVISION** = exemption is not available to certain foreign corporations the stock of which is owned primarily by nonresidents (§883(c)(1))

(ii) **Note**: income tax treaties typically exempt treaty residents of one contracting state from tax by the other contracting state resulting from transport income from international traffic derived in that other contracting state (See, Art. 8 of the US Model Treaty)

(iii)

IV. The Foreign Tax Credit

A. Overview

B. Statutory Framework

1. 901(a) authorizes the foreign tax credit subject to the limitations of 904

2. available to US citizens and residents including US corporations (§901(b))

a) under certain facts and circumstances, the credit is also available to nonresident aliens and foreign corporations engaged in a trade or business in the US (§906)

3. available for

a) foreign income taxes paid (§901(b))

b) any foreign taxes paid in lieu of income tax(§903)

4. tax credit is ***elective*** *- - if the tax payer elects to take the credit <u>no deduction for foreign taxes paid is available</u> (275(a)(4)(A)*

a) **Note:** in most circumstances a taxpayer will elect to take a credit **<u>which offsets US taxes dollar-for-dollar</u>** rather than a deduction that may only offset YS taxes by 35 cents for every dollar deducted if the tax rate is 35%

b) Note: if foreign taxes are not creditable, then deduction under §164(a)(3) becomes attractive

(1) Deduction may also be preferable if the US taxpayer has excess credits

(2) Even in the presence of excess credits a deduction may be preferable <u>because it can be carried forward to other taxable years</u>

5. generally the taxpayer accounts for the foreign tax credit in a manner consistent with the taxpayers method of accounting

a) **Note**: §905 permits a taxpayer to claim a foreign tax credit in the year the foreign taxes **accrue** <u>**even if the taxpayer is a cash basis taxpayer**</u>

b) **Note**: upon receipt (or deemed recept) of certain dividends, some shareholders are permitted an indirect tax credit for any foreign taxes the paying corporation paid on its foreign source income used to make the dividend distributions (§901) (actual dividend) and §906 (deemed dividend))

C. Eligibility

1. taxpayers may credit income taxes paid to foreign countries

a) **NOTE:** not credit is available for income taxes paid to any foreign country which the US does not recognize or maintain diplomatic relations with , or which provides support for acts of international terrorism (§901(j))

b) **NOTE:** the President can disallow the foreign tax cerdti to resident aliens who are citizens of a foreign country that does not allow US citizens resident there a similar credit for taxes paid to the US or other countries

*2. any taxpayer that is a member of a **partnership** or a **trust** may claim the credit as a proportionate share of the qualifying foreign taxes paid by the entity (§901(b)(5))*

D. Creditable Taxes

1. requirements that must be met

a) the foreign levy must be a tax not a voluntary payment <u>AND NOT</u> a payment for a specific right or services (e.g. royalty payment)

b) it may be necessary to determine whether the payment is a **separate tax** or **part of a unified tax** in order to evaluate creditability

c) necessary to determine if the tax is an income tax **when viewed through the lens of US tax principles**

d) if the tax is not an income tax, **it still may be creditable** as an "in-lieu-of" tax under §903

e) if the foreign levy is a creditable income tax → determine

(1) who can claim the credit?

(2) what is the amount of the creditable tax that is paid?

2. *Is the Foreign Levy a Tax?*

a) if the payment is voluntary it is not creditable (Reg. §1.901-2(e)(5))

(1) **Note:** even if the payment is involuntary **it will not be creditable** unless it is a payment to a foreign government as a taxing authority (Reg. §1.901-2(a)(2)(i))

(2) **Note**: a sticky issue concerns creditability of a purported tax payment that is in fact a payment for a "*specific economic benefit*" - - in which case **<u>it is not</u>**

(a) The Regulations attempt to distinguish between this variety of broad government services and a payment for a specific economic benefit (see Reg. §1.901-2(a)(2))

(b) "*specific economic benefit*" menas an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the generally imposed income tax (Reg. §1.901-2(a)(2)(ii))

(c) **Note:** "*dual capacity* taxpayer"

(i) in some cases a US taxpayer **pays a foreign tax that <u>includes a payment for a specific economic benefits as well as payment for general governmental services</u>**

(a) In such cases the payment is ***bifurcated*** into two components

(i) The noncreditable payment for a specific economic benefit

(ii) A creditable payment for the excess paid **if the payment otherwise satisfies the creditability requirements (Reg. §1.901-2(a)(2)(i))**

(b) a dual capacity taxpayer must establish the creditable portion of the payment under either the "*facts and circumstances*" method or the *safe harbor method*

(i) *"FACTS AND CIRCUMSTANCES*" = if the taxpayer can establish that an otherwise creditable levy **<u>is not</u>** paid in exchange for a specific economic the payment is creditable (Reg.. §1.901-2A(c)(2)

(ii) *SAFE HARBOR* method = uses the following formula

$$(A - B - C) \times \frac{D}{1 - D}$$

A= Gross receipts

B= Expenses computed under the general foreign income tax rules

C=total "tax" paid by the dual capacity taxpayer

D = the general tax rate

b) taxpayer must exhaust all effective and practical means of lowering foreign tax payments **but need not tilt at windmills**

(1) taxpayer need not litigate foreign tax liability if the taxpayer has obtained in good faith from a foreign tax advisor and opinion that litigation would be unsuccessful (Reg. §1.901-2(e)(5)(i))

3. *Is the tax a separate tax or part of a broader tax?*

a) Necessary to ascertain whether the tax stands alone or is part of a broader tax

b) Creditability of the tax is determined by looking at all taxpayers subject to the tax rather than on a taxpayer-by-taxpayer basis (Reg. §1.901-2(a)(1)

c) Determination of whether the tax is **a separate levy or part of a broader levy** is made using several principles articulated in the Regulations (Reg. §901-2(d)(1)) not foreign tax principles

(1) A levy is **a separate levy if** the tax base differs in kind for different classes of taxpayers (Reg. §1.901-2(d)(3) Ex. 2)

4. *is the tax an income tax?*

a) A tax is **not** creditable if the tax is designed to tax US residents or citizens only to the extent each $1 of foreign tax reduces US taxliability by $1 (a "soak up tax")

b) Because the credit is aimed at preventing international double taxation → the only payment allowed as a tax credit against US income is a foreign income tax under §901

c) Foreign taxes that are income taxes in the US sense of the term can qualify for the credit <u>even if imposed by a political subdivision or local authority of a foreign country</u>

(1) Contrast = US state and local taxes are not creditable - - can only be deducted

d) Note: foreign taxes that are not "income taxes" in the US sense of the term <u>may be deductible</u> (§164(a)(3)

e) Regulations provide guidance (or a little)

(1) A foreign tax is creditable only if its "predominant character…is that of an income tax in the US sense"

(a) The foreign tax must be "*likely to reach net gain*" (Reg. §1.901-2(a)(1)(ii) and (3)(i))

(b) Tax is "likely to reach net gain" if it satisfies 3 requirements

(i) Realization

(a) Met if, on the basis of its predominant character, a foreign tax is imposed only upon or subsequent to, the occurrence of an event that would result in realization under the Code (Reg. §1.901-2(b)(2)

(ii) Gross receipts

(a) Requirement is met if the foreign tax uses a tax base of gross receipts from the disposition of property, or if there is no disposition or the disposition is between related parties, the tax base is computer under a method that is likely not to exceed the fair market value of the property involved (Re. §1.901-2(b)(3))

(i) **Note:** a tax not based on gross receipts **may still be creditable** if it is intended to reach the same tax base

(iii)Net income

(a) Requirement is met if foreign tax is computer by reducing gross receipts by the cost of producing the income (including capital expenditures) determined under "reasonable principles" (Reg. §1.901-2(b)(4))

(i) **Note**: a foreign tax law is *deemed* to permit the recovery of significant costs even if there are timing differences when compared with US law unless the timing differences effectively deny the deduction

(ii) **Note:** even if the foreign tax law does not permit recovery of a significant cost the **tax may still be creditable if there is an allowance that effectively compensates for the denial**

(b) **Note**: one of the **factors taken into account in determining if this requirement is met** = whether a loss in one activity in a t/b is allowed to offset profits in another activity in the same trade or business

(i) If an offset is allowed it need not be in the same taxable period in order to insure creditability

(ii) **Note**: it is not necessary that a foreign tax permit an offset against profits from a different t/b or profits from investment activity that **or** that losses be allowed to offset profits from related entities in order for a foreign tax to be creditable (Reg. §1.901-2(b)(4)(ii))

f) Is the tax in lieu of an Income Tax?

(1) creditable under the "in-lieu-of" tax under §903 if the tax is imposed in lieu of a tax on income that is generally imposed

(2) to qualify

(a) the foreign country must have a general income tax law that would apply to the taxpayer but for the in-lieu-of tax

(b) the general income tax is not imposed on the taxpayer because of the in-lieu-of tax (Reg. §1.903-1(a)(2) and (b)

(c) **Note**: the taxpayer cannot be subject to the general income tax and the in-lieu-of tax

(d) **Note:** it is not a requirement that the in-lieu-of tax be imposed because of administrative difficulty in applying the generally imposed income tax (Reg. §1.903-1(a))

(e) Note: a *"soak up"* in-lieu-of tax will not be creditable (Reg. §1.903-1(b)(2))

g) Who can claim the foreign tax credit

(1) US citizens, residents and domestic corporations are entitled to a foreign tax credit

(2) Nonresidents that are subject to US tax on income effectively connected with conduct of a US tradde or business may be able to credit foreign taxes paid with respect to that income (§906)

(3) Who is the taxpayer?

(a) *Biddle v. Comm'r* = US rather than foreign standards apply in determining who is the taxpayer

(b) The Regulations consider the taxpayer of a foreign tax to be the person whom foreign law imposes legal liability for tax (Reg. §1.901-2(f)(1))

(i) **Note**: a taxpayer who is legally liable for a foreign tax that is **paid** can qualify for a credit <u>**even if the payment is made by someone else**</u> (Reg. §1.901-2(f)(12))

(ii) **Note**: a credit may be available if the government's assumption of the tax liability is compensation for services rendered or goods sold or leased to the government

(a) This regulations permits a US taxpayer to enter into a "*net contract*" with a foreign government that assures a taxpayer a fixed after-tax contract price for services rendered or goods sold or leased to the foreign government (*Amoco Corp. v. Comm'r* (7thCir. 1998)

(b) Any tax liability that is <u>assumed</u> by another party (*e.g.* a foreign government) is considered income for US tax purposes (Reg. §1.901-2(f)(2)(ii))

h) What is the Amount of the Creditable Foreign Income Tax

(1) An amount of tax paid to a foreign government is not creditable to the extent that it is reasonably certain that the amount will be refunded, credited, rebated or forgiven (Reg. §1.901-2(e)(2))

(a) If a foreign government ***either directly or indirectly*** returns a portion of a tax payment as a subsidy, the tax payment to the extent of the subsidy is not creditable (§901(i))

5. *Computing the Direct Credit*

a) The credit reduces the US tax liability dollar-for-dollar

b) **Note**: the tax credit under §901 is <u>subject to limitations under §904</u> (infra)

(1) Thus, without additional information concerning the nature and source of the income that generated the foreign tax, the amount of the foreign tax credit permitted for a particular taxable year cannot be determined

6. *Computing the indirect credit*

(1) a US corporation operating through a foreign branch is taxable in the US on the branch income and <u>**can credit foreign income taxes on the branch income**</u>

(a) **Note:** once the subsidiary distributes the foreign earnings in the form of a dividend =m the US parent is taxable on the income <u>**at that point**</u> may receive a foreign tax credit for foreign taxes paid by the distributing corporation with respected to income used to make the dividend payments (*see discussion of subpart F, infra*)

b) Minimum Ownership Requirements

(1) To qualify for the indirect tax credit, a domestic corporation **<u>must own at least 10% of a foreign corporation's voting stock</u>** (§902(a))

(a) Purpose of the req = intended to make the indirect tax credit unavailable where a domestic corporation owns stock of a foreign corporation as a portfolio investment

(b) **Note**: there is **no indirect credit for <u>dividends received by an *individual*</u>** owning at least 10% of the voting stock of aforeign corporation doing business abroad even thoug that invidual is taxed on the dividend originating from foreign earnings that are taxed by a foreign country

(2) **Note**: can apply to 6^{th}- tier subsidiaries (§902(b)(1) and (2))

(a) For lower tier subsidiaries, the ownership percentages are multiplied together and the indirect credit applies if the resulting product is at least 5% (§902(b)(3)

(i) **If the 5% test is satisfied with regard to lower-tier subsidiaries** then foreign taxes paid by the first tier subsidiary include the taxes it is deemed to have paid with respect to dividends distributed to the lower-tier corporations

(ii) **Stated another way** = the US parent corporation receives a larger foreign tax credit on dividends it receives from the first tier subsidiary which has itself received dividends from lower-tier subsidiaries

c) Amount of Tax Deemed Paid

(1) Assuming the foreign income taxes paid by a foreign subsid are creditable income taxes **AND** THAT THE MINIMUM OWNERSHIP REQUIREMENTS ARE SATISFIED → the portion of foreign taxes deemed paid by a US parent corporation (under §902(a)) is determined using the formula below

(a) $Post - 1986 ForeignTaxes \times \frac{Dividends}{Post - 1986 UndistributedEarnings}$

(b) "*post-1986 foreign income taxes*" = refers to taxes paid after 1986, including the year in question to the extent that the taxes have not already been deemed paid by the corporate parent (§902(c)(2))

(c) "*post-1986 undistributed earnings*" = refers essentially to the corporation's earnings and profits determined under Us tax principles (*see,* §316) that a corporation has accumulated (*i.e*. distributions reduce post-1986 undistributed earnings) after 1986 and through the year of distribution (*US v. Goodyear Tire and Rubber Co.* (S.Ct. 1989)

(2) **Note**: a dividend distribution from a foreign subsidiary to a US parent corporation may involve both the indirect and direct tax credit

(3) **Note:** under §245, the dividends attributable to the effectively connected income are eligible for a dividends received deduction of up to 100% **depending on the degree of ownership** (*see*, §243 and 245(b))

(a) To the extent that §245 applies, no foreign tax credit is available for taxes attributable to the dividend from US effectively connected inco9me (§245(a)(8)).

7. *Limitations on the Foreign Tax Credit*

a) Overview

(1) A minimum holding period for purpose of crediting foreign taxes associated with **both direct and indirect foreign source dividends**

(a) In general, a taxpayer qualifies for credit with respect to a dividend **only if a 16-day holding period for the dividend-paying stock** (46-day holding period for certain dividends on preferred stock) is satisfied (§901(k))

(2) §904 limits the foreign tax credit to foreign income taxes imposed on foreign source income to the extent those taxes do not exceed the US income tax on that foreign source income

(a) specifically, §904 provides that the total amount of the foreign tax credit cannot exceed the same proportion of the tax against which the credit is taken which the taxpayer's foreign source taxable income bears to a worldwide taxable income

(b)

(c)

(d) $\frac{X}{U.S. Income\ Tax} = \frac{Foreign\ Source\ Income}{World\ Wide\ Taxable\ Income}$

(e) Where

X = the amount of creditable foreign income taxes that can be credited for the taxable year

Solving for X yields:

(a)

(b) $X = U.S.\ Income\ Tax \times \frac{Foreign\ source\ income}{Worldwide\ taxable\ income}$

(3) under §904(c) any excess creditable taxes that cnnot be immediately credited because of §904(a) limitation can be carried back two years (requiring an amended return) and carried forward five years, subject to the §904(a) limitation

(a) **Note:** excess credits CANNOT BE deducted (§904(c), §275(a)(4)(A))

(4) "per country" limitation

(a) designed to prevent averaging of highly taxed foreign source income with that taxed at lower rates

(b) **operation of the limit** = under the "per country" limitation foreign income taes from each country are subjected to the §904(a) limitation separately so that the numerator of the §904 ration (*i.e.* foreign source income) is applied country-by-country

(5) But for the above limitation, a taxpayer can deduct any withholding tax and need not gross up any underlying taxes under §78 in the case of any indirect credit that is disallowed

b) Separate "Baskets"

(1) Each specially designated type of income is placed into a "basket" to which the §904(a) limitation is applied (§904(d))

(a) Why? = congress wanted to prevent US taxpayers from arranging their affairs to maximize the foreign tax credit at the expense of US taxes on US source inform

(b) The §904(d) limit for each basket is:

(c)

(d) $$\frac{X}{U.S.\ income\ tax} \equiv \frac{Foreign\ source\ income\ in\ the\ basket}{Worldwide\ taxable\ income}$$

(e) Where X= the amount of creditable foreign income taxes that can be credited for the taxable year

(f)

(g) Solving for X yields:

$$X = U.S.\ income\ tax \quad \times \frac{Foreign\ source\ income\ in\ basket}{Worldwide\ taxable\ income}$$

(2) §904(d) creates nine (9) separate basket

(a) three pertain to special kinds of export companies that usually are not subject to heavy foreign taxation (§904(d)(1)(F), (G) and (H))

(b) two of these baskets apply to income from specific industries – financial services (*i.e.* banking) and shipping (§904(d)(1)(C) and (D)

(c) three pertain to various types of passive income (§904(d)(1)(A), (B) and (E)

(d) one is the overall or residual basket which applies to business income (§904(d)(1)(I))

(3) **Note:** congress has waived the limitation for certain de minimis foreign taxes paid by individuals

(a) Individual with $200 ($600 for joint filers) or less of creditable foreign taxes is exempt from the foreign tax credit limitation **provided that the taxpayer has no foreign source income other than qualified passive income** (§904(j))

(4) Passive Income Basket

(a) *e.g.* interest and dividends

(b) the most important categories of income that fall into the passive income basket are(§904(d)(2)(A)(i), 954(c)(1):

(i) interest

(ii) rents

(a) possible exception: rents derived from an active t/b

(iii)royalties

(a) possible exception: royalties derived from an active t/b

(iv)annuities

(v) net capital gains

(c) exception = HIGH-TAXED PASSIVE INCOME - - A.K.A. "HIGH TAX KICK-OUT" (§904(d)(2)(A)(iii)(III))

(i) motivation behind this exception=congress did not want taxpayers to average high-taxed passive income with low-taxed passive income

(ii) "*high-taxed passive income*" = referrs to income subject to an effective foreign tax rate exceeding the highest applicable US rate (*i.e.* corporate or individual, depending on the taxpayer) on the income (§904(d)(2)(F)

(iii)when high-taxed income is removed, it is placed in the overall basket (§904(d)(1)(I))

(5) High Withholding Tax Interest Basket

(a) Applies only to interest income subject to a foreign withholding tax of **<u>at least 5%</u>** (§904(d)(1)(B))

(b) Does not apply to interest received in the conduct of financing certain export activities (§904(d)(2)(B), (G).

(i) **Note:** export interest is not treated either as passive income or as high withholding tax interest **<u>even if the withholding rate is at least 5%</u>**

(a) Why? = congress was concerned that applying the separate limitation rules might discourage US export sales

(6) Noncontrolled Section 902 Dividend Basket

(a) Dividends received by a corporation form a "noncontrolled section 902 corporation" (also known as '*10/50 companies'*) <u>are segregated in a separate basket and do not fall in the passive income basket</u> (§904(d)(1)(E))

(i) Category covers dividends from a foreign corporation in which a US corporation-taxpayer owns at least 10% of the voting stock and US shareholders (*i.e.* those owning at least 10% of the voting stock) as a group own 50% or less of the stock measured by coting power or value (§904(d)(2)(E)

(ii) Each 10/50 company is treated separately for §904 limitation purposes

(a) dividends from each corporation placed in a separate basket to prevent averaging of high-taxed and low-taxed dividends from different 10/50 companies

(b) selection of basket for dividends depends on the level of ownership

(i) dividends received by a US corporation owning less than 10% of the voting stock of the foreign distributing corporation **are placed in the passive income basket** (§904(d)(2)

(ii) if the US corporation owns 10% or more of the distributing corporation → dividends paid by the 10/50 fall into the §904(d)(1)(E) basket

(iii)if the US corporation owns 10% or more of the distributing corporation and the US shareholders as a group ownmore than 50% → the dividends received are subject to a *"look through"*

(a) "*look through*" = where the distributing corporation's underlying income determines what basket or baskets the dividends are placed in

(iv)dividends received by a US individual from a foreign corporation are placed in the general passive income basket

(a) **<u>unless</u>** the individual owns 10% or more of the voting stock and US shareholders (*i.e.* those owning at least 10% of the voting stock) as a group own more than 50% of the distributing corporation's stock in which case "*look through*" rule applies

(v) **Note:** there is no non-controlled §902 basket for dividends received by individual shareholders

(vi)For a US corp, placing the dividends form a 10/50 company in a separate basket strikes a middle ground between

(c) placing them in the passive income basket when the indirect tax credit available to a corporation-shareholder may related to active trade or business that the US taxpayer indirectly helped to produce through its subsid & "*looking through*" the dividend and the related taxes to ascertain the type of income that made the dividends possible, placing the dividend, or an allocable portion, in the basket corresponding to the underlying income earned by the foreign corporation

(i) **<u>INSTEAD</u>** Congress opted to isolate the dividend incomein separate baskets where the US corporation-shareholder can qualify for an indirect tax credit

(ii) **<u>This means</u>** that a corporation-shareholder may be able to take an indirect tax credit for taxes paid by the subsidiary even though the income giving rise to the credit would have been placed in different baskets if a *look-through* rule applied

(a) May permit the averaging of high-tax and low-tax income at the subsidiary level

(7) Look-through rules

(a) Whre a foreign subsidiary is a controlled foreign corporation → a US taxpayer owning at least 10% of the voting stock must "*look through*" any distribution of dividends, interest, rents and royalties to the distributing corporation's underlying income (§904(d)(3))

(i) Rules **<u>also apply</u>** to a *deemed* distribution by a controlled foreign corporation with subpart F income

(ii) "*controlled foreign corporation*" = a corporation more than 50% of the stock of which measured by voting stock or value is owned by US shareholders (*i.e.* those owning at least 10% of the voting stock)

(b) purpose of the "*look through*" rules = equate the treatment of a controlled foreign corporation with a branch

(i) for tax credit purposes → a US parent is treated as earning the income earned by a foreign subsidiary

(ii) **Two basic scenarios**

(a) if a US parent is taxable on income (*e.g.* foreign personal holding company income) as it is earned under subpart F → the income taxed to the US parent is placed in those baskets that are appropriate for the income earned by the foreign subsidiary

(b) if the US parent is not taxed on income earned by the foreign subsidiary <u>until it is distributed in the form of a dividend, interest, royalties or rent</u> → the distribution is allocated to baskets in accordance with the income of the foreign subsidiary that is deemed to be used to make the distribution

(c) ***<u>KEY FEATURE OF THE LOOK THROUGH RULE</u>*** = the allocation of the distribution made by a controlled foreign corporation to the income earned by that corporation

(i) a dividend subject to the allocation rule = allocated pro rata to the income earned by the distributing corporation

(ii) interest, royalties and rent paid by a controlled foreign corporation to a US taxpayer owning 10% or more of the corporation's voting stock = allocated to the recipient's baskets in the same way as deductible payments are allocated to income generally

(iii)**Note SPECIAL RULE FOR INTEREST PAYMENTS**

(a) Interest payments received by a US shareholder from a controlled foreign corporation = allocated

(i) first to passive income earned by the controlled foreign corporation

(ii) then interest is **APPORTIONED** among classes of gross income in proportion to asset value

(8) Treatment of Foreign Losses

(a) §904(f)(3) provides for recapture of foreign losses on a disposition of t/b property used outside the US

(i) gain that would normally be foreign source income or not recognized for tax purposes **is recaptured as US source income to the extent of any unrecaptured foreign losses**

(b) §904(f)(1) provides a recapture scheme for overall foreign losses (OFL)

(i) the rule **only applies** to income in a subsequent year in the basket which gave rise to the loss in the earlier year

(ii) only 50% (or greater if the taxpayer so **elects**) of a taxpayer's foreign earnings (limited by the amount of the previous loss) is resourced as US source income for purposes of the foreign tax credit limitation

(iii)taxes on the other 50% of the foreign earnings are still creditable

(c) rules for applying §904(f) to the "*baskets*" found in §904(f)(5):

(i) for any taxable year, a foreign loss in one basket (separate limitation loss) is allocated to income in other baskets before offsetting US source income

(ii) in a subsequent taxable year, foreign income attributable to the loss basket is first treated as US source income to the extent US source income was previously offset and then is treated as foreign source income placed in any baskets the income of which was previously offset

(9) Treatment of US Losses

(a) If US taxpayer has **income from a foreign source** <u>but a loss from US sources</u> → the US loss is allocated among the taxpayer's foreign income baskets (§904(f)(5)(D))

(b) If a US taxpayer has both a loss from US source income and a loss in a foreign income basket → the loss from the foreign basket is allocated among the remaining foreign baskets and the US loss is allocated to the income remaining in those baskets

(c) Note: if US losses in one year offset foreign income there is no counterpart to §904(f)(1) in a subsequent year that changes US source income to foreign source income

(10) Tax Credit Sources

(a) The limitation formula in §904(a) as applied to the various baskets of §905(d) is **intended, in part**, to allow a foreign tax credit **<u>only for foreign income taxes on foreign source income</u>**

(b) §904(g) was enacted to prevent taxpayers from turning US source income into foreign source income in order to increase the foreign tax credit

(i) the **<u>special rule in §904(g)</u>** resources the interst payments as US source income by looking through the controlled subsidiary to determine the actually source of the income (*i.e.* interest paid by a US payor

(ii) undermines the taxpayer's attempt to turn US source income into foreign source income in order to increase the foreign tax credit

(iii)**<u>the effect of §904(g)</u>** is to preserve US taxation of US source income

V. Inter Company Pricing

A. Overview

*1. **Note**: §482 IS A WEAPON AVAILABLE **ONLY TO THE IRS** (§1.482-1(a)(3))*

a) Is an umbrella-like provision that is available to the IRS if a number of narrower provisions addressing certain specific transactions prove inadequate

(1) Examples of this other provisions

(a) Controlled foreign corporation provisions = §951-960 address the relationship entre US parent corporations and subsidiaries engaged in certain specified activities

(b) §367 addresses the proper allocation of income on asset transfers from a US person to certain related foreign persons

*2. §482 authorizes the IRS to allocate gross income, deductions and credits between related taxpayers (including unincorporated t/b of a single entity) **to the extent necessary to prevent evasion of taxes or clearly to reflect the income of related taxpayers***

3. the §482 Regulations

a) based on the principle that transactions between related parties ("controlled transactions") should be evaluated on an "arm's length basis"

(1) "*arm's length basis*" = standard asks "how would unrelated parties structure the transaction in an uncontrolled transaction?"

(2) rejects the formularly methodologies like those in most states within the US

4. Note: §482 can apply even in the absence of a tax avoidance motive

a) Can apply in any situation where two taxpayers are "owned or controlled directly or indirectly by the same interests"

(1) "*control*" = the IRS focuses on the realities of the situation **rather than whether there is formal legal control** (Reg. §1.482-1(i)(4))

(2) **Note:** corporations owned by <u>related, overlapping shareholders can also be subject to §482</u> (see, *DHL Corp. v. Comm'r* (Tax.Ct.1998)

b) in the <u>international context</u> §482 is often applied to allocate income from a foreign parent to a US subsidiary

(1) also applicable in the converse situation → to allocate income from a foreign subsidiary to a US parent

5. steps

a) income, credits and deductions are allocated among related parties under §482

b) the source of the allocation items is **determined under §861, et sec.**

B. Application of §482 in General

1. "arm's length" character of a transaction entre related parties (i.e. a "controlled transaction" is best tested by comparing the results of the transaction in question with the results of unrelated taxpayers engaged in comparable transactions under comparable circumstances (i.e. "uncontrolled transaction")

a) "comparability" of the two transactions can be establish using the following factors(Reg. §1.482-1(d)

(1) functions

(a) to be comparable, the parties normally should perform the same functions with respect to the transactions

(2) contractual terms

(a) the risks borne by the parties to each transaction should be similar

(i) relevant risks =

(a) market risks

(b) research risks

(c) financial risks

(d) credit and collection risks

(e) general business risks

(b) in comparing prices, the contractual terms (*e.g.* quantity, duration, warranty) of the two transactions should be comparable

(3) economic conditions

(a) (*e.g.* market alternatives for buyers and sellers, similarity of geographic markets, market size and composition) should be similar

(4) the nature of the property or services

b) **Note**: transactions may be comparable to another transaction **<u>even if it is not identical</u>**, although adjustments may be required

(1) Adjustments may be based on commercial practices, economic principles or statistical analysis (Reg. §1.482-1(d))

(a) Regulations also describe special circumstances that should be taken into account in determining and adjusting comparability

2. the §482 Regulations offer a variety of different methods that can be used to determine the arm's length price in transactions between controlled entities

a) adopt the "best method rule" rather than imposing a hierarchy of methods (Reg. §1.482-1(c)(1))

(1) determining which method is the "*best*", the Regulations look to the degree of comparability between the controlled transaction and the uncontrolled comparables and also the quality of the data and assumptions used in the analysis

b) **Note:** the Regulations recognize that valuation difficulties can produce a range of arm's length prices (Reg. §1.482-1-(e))

(1) The prices set between related parties need not be a specific point in that range as long as the taxpayer's results fall within the range ("*the arm's length range*") derived from two or more applications of the same pricing method to different comparables

C. Application of §482 to Specific Transactions

1. Sales

a) Determined in accordance with the arm's length price that an unrelated purchaser would have paid under the same circumstances

b) Under the "best method rule" the arm's length price for a particular transaction should be determined using the method which provides the most accurate measure of an arm's length result

(1) Regulations outline the following pricing methods (Reg. §1.482-3(a)

(a) The comparable uncontrolled price (CUP) method

(b) The resale price method

(i) Use = may generally be appropriate when a manufacturer sells products to a controlled distributor which, without further processing or the use of significant intangibles, resells the products in uncontrolled transactions

(c) The cost plus method

(i) Use = may be appropriate when a manufacturer sells products to a controlled taxpayer that resells after further processing or the use of significant intangibles

(d) The comparable profits method

(i) Use = if data is available, ordinarily provides the most accurate measure of an arm's length price

(ii) Generally courts have expressed a preference for this method where comparable transactions are available (see, *Compaq Computer Corp. v. Comm'r* (Tax.Ct.1999)(CUP method chosen over cost plus method where comparable uncontrolled sales exist)

(e) The profit split method

(f) **Note:** in the CUP, resale price and cost plus methods, arm's length results are determined

(i) from the price charged in comparable uncontrolled transactions for comparable goods; OR

(ii) from the gross profit margins of comparable uncontrolled resellers (resale price method); OR

(iii)gross profit margins of comparable producers (cost plus method)

(g) Note: the comparable profits method and the profit split method apply not only to sale of tangible property but also to transfers of intangible property

(2) **Note:** a special rule to prevent a US purchaser from inflating the price paid to a related foreign corporation in order to minimize the gain on eventual resale

(a) §1059(A) prevents a US purchaser of inventory from a related party from taking as its basis for determining gain on resale and amount greater than the prices used in determining the amount of customs duties

(b) **Note**: some taxpayers may prefer to pay higher customs duties in order to inflate basis for income tax purposes

c) Comparable Uncontrolled Price Method

(1) Under the method → the price for tax purposes *deemed* paid by Subco to Parentco is determined on the basis of "*uncontrolled sales*" made by Parentco to unrelated buyers (Reg. §1.482-3(b))

(a) Comparable sales of the same product between two unrelated parties would provide information

(b) Determination of comparability →

(i) Differences in the product or the circumstances surrounding the sale (*e.g.*, volume discounts, whether the purchaser is a wholesaler or retail customer) are taken into account

(ii) **Note**: some adjustments to uncontrolled transactions that are not precisely comparable is permitted in order to make them comparable (Reg. §1.482-3(b)(2))

(a) The Regulations state that the following differences entre controlled and uncontrolled transactions would not prevent their use as comparables in applying the comparable uncontrolled method

(i) Differences in contractual terms of transportation and insurance

(ii) Differences in warranty obligations

(iii) Minor physical differences of the property sold

(iv) Differences in volume sold

(v) **Note**: adjustments would be necessary to account for these differences

(vi) **Note**: if the property sold in a controlled transaction has a trademark → this may preclude use of the CUP **<u>if the trademarks' effect on price cannot be reasonably estimated</u>** (Reg. §1.482-3(b)(4) Ex.2)

d) Resale Price Method

(1) Useful where CUP method is not available

(2) Particularly useful in situations where the related purchaser (*e.g.*, Subco) does not add significant tvalue to the product (*e.g.,* if the purchaser is a distributor) **<u>OR</u>** does not use significant intangibles (Reg. §1.482-3(c)

(3) Method is intended to measure the value of the distribution function performed by a related purchaser

(4) Process

(a) Star with the applicable resale price charged by Subco to unrelated purchasers

(b) Determine an appropriate gross profit

(c) Subtract this gross profit figure from the applicable resale price charged by Subco to get the *deemed* sale price

(d) **Note**: "*appropriate gross profit*" is determined by multiplying the applicable sales price by and appropriate gross profit margin which is essentially profit as a percentage of gross sales in uncontrolled transactions

(5) In order to apply this method there must be uncontrolled purchases and resales by the reseller in question (*i.e.,* Subco) or the same information from other resellers selling in the same or similar market

(a) **Note:** adjustments may have to be made to the gross profit margin **IF** the uncontrolled and controlled transactions differ in some respect

e) Cost Plus Method

(1) Is most appropriate in those situations where there are no comparable unrelated sales **AND** the related purchaser does more than mere distribution (*e.g.,* the subsidiary adds substantial value to the product **OR** uses significant intangibles) (Reg. §1.482-3(d))

(2) The **costs of the company selling to the related party** are determined and appropriate gross profit market is applied to determine the deemed sales price paid by the related party (Reg. §1.482-3(d))

(3) **Note**: if there are differences entre the controlled and uncontrolled transactions → adjustments are required

f) Other Methods

(1) EI Du Ponte de Nemours & Co. v. US

(a) Court relied on two methods presented by the IRS in allocating income

(i) Method 1 =The ration of gross income to total operating costs (sometimes referred to as the “Berry ratio”) of DISA was substantially greater than a broad sampling of firms which were functionally similar

(ii) Ration of return on capital of 1,113 companies that did not necessarily have functional similarities to DISA, but instead reflected a comprehensive selection of industry as a whole

(2) Sundstrand Corp. v. Comm’r

(a) Court determined a transfer price on the basis of typical discount from the catalog price in the taxpayer’s industry

(i) The court looked at other the discount rates enjoyed by other distributors of aerospace parts in general, finding that a discount off catalog prices of at least 10% was prelavent

(a) By imposing a 20% discount rate, the court lowered Sundstrand’s cost of goods sold thereby raising its taxable income

2. *Services*

a) The corporation purchasing the services is deemed to pay an arm’s length price to the corporation performing the services

(1) Arm’s length price is *deemed* to equal the direct and indirect costs incurred in connection with the services performed

(a) Direct costs could include → transportation and employee salaries

(b) Indirect costs could include → a portion of the depreciation, rent, property taxes and other overhead expense of parentco attributable to its in-house services that were provided to Subco

(2) **Note**: the Regulations do not generally require the allocation of a profit for services performed entre related parties ***IF*** the services are incidental to the business function of the corporation (Reg. §1.482-2(b)(3))

(3) Allocation process

(a) Regulations make a distinction entre services rendered primarily for a related taxpayer's benefit **AND** those which are supervisory in nature

(b) **Note**: if the services performed for a related party are an "*integral part*" of the business activities of the provider → the arm's length charge **must include a profit factor equal to that charged for similar services to an independent party**

(i) **A service is an *"integral part of business*" if**

(a) The rendering entity is in the business of providing the service to unrelated parties

(b) One of its principal activities (*i.e.,* 25% or more) is providing such services to related parties

(c) The rendering entity is peculiarly capable of performing such services and they are a principal element in the operation so fhte recipient (*e.g.,* if Partneco were an auto financing company that requires its customers to have life insurance and then convinces those customers to buy the insurance from Subco); **OR**

(d) The recipient has received a substantial amount (*i.e.,* 25% or moer of its total costs) of services from related parties (Reg. §1.482-2(b)(7))

3. *Rentals of Tangible Property*

a) The Regulations deem the user to havepaid an arm's length rental if the lease does not so provide (Reg. §1.482-2(c))

(1) An "*arm's length rental*" is the amount which would have been charged on a transaction between unrelated parties

(2) **Note**: in the case of **<u>subleases</u>** →the arm's length prices is an amount equal to the owner's deductions (*i.e.,* rent, maintenance, utilities, etc.)

(a) There is NO *deemed* profit in sublease situations (Reg. §1.482-2(c)(iii))

4. *Licenses of Intangible Property*

a) Payments to a related party for a license or transfer of an intangible may be reallocated by the IRS if the payments are not deemedi to be at arm's length

b) "intangible property" includes any patent, know-how, copy-right, trademark, franchise, license, contract or similar item (Reg. §1.482-4(b)

c) three (3) methods for determining an arm's length price for the transfer of an intangible

(1) the comparable uncontrolled transaction (CUT) method

(a) the arm's length consideration for a controlled transfer fo intangible property is equal to the consideration charged in a comparable uncontrolled transaction (*i.e.* transactions entre unrelated parties) (Reg. §1.482-4(c))

(b) an uncontrolled transaction is considered "*comparable*" if the intangible to be compared are

(i) in the same class of intangibles

(ii) related to the same type of products within the same general industry; **AND**

(a) translation = *comparable* if they are used in connection with similar products within the same market and have similar profit potential (Reg. §1.482-4(c)(2)(iii))

(iii)have substantially the same profit potential (*i.e.,* net present value)

(c) Note: if differences in contractual terms OR economic conditions ARE SIGNIFICANT → the CUT method will be UNAVAILABLe

(2) the comparable profits method (CRP)

(3) the profit split method

(4) Note: generally the CUT method (the counter part of the CUP method) is likely to be the best method for determine the arm's length price

(5) Periodic Adjustments

(a) Payments to a related party for a license or transfer of intangible must be "*commensurate with the income*" attributable to the intangible (§482 second sentence)

(i) Practical effect of the "*commensurate with…)* language = royalty arrangements entre related parties can be periodically adjusted by the IRS to reflect changing market conditions

(b) Protections from periodic adjustments rule

(i) If the CUT method was used to determine an arm's length royalty in year 1 and the intangible transfer in the uncontrolled transaction was made under substantially the same circumstances as those in the controlled transaction → no adjustment may be made in a subsequent year (Reg. §1.482-4(f)(2)(ii)(A))

(ii) If the CUT method is used with respect to an uncontrolled transfer of a different <u>but comparable intangible</u> → no later adjustment will be made if certain specific requirements are met – including a finding that the aggregate profits actually earned (or cost savings realized) by the controlled taxpayer from the exploitation of the intangible are not less than 80% nor more than 120% of the prospective profits (or cost savings) that were foreseeable when the comparability of the uncontrolled agreement was established

(6) Identification of the Developer

(a) By arguing both corporations developed the intangible so that **no royalty is due from Subco to Parentco** they might avoid the transfer pricing problems - - BUT FOR THE CODE THIS WOULD WORK

(b) **The Regulations** = when two or more members of a controlled group undertake the development of an intangible →

(i) one member will be regarded as the developer (*i.e.,* the owner)

(ii) the others as assistants which will be *deemed* to have paid and arm's length royalty to the developer (Reg. §1.482-4(f)(3))

(iii)**Note**: this rule is subject to the cost sharing provisions discussed, *infra*

(c) Determining the "*developer*"

(i) Great weight is given to the extent that each related party bears the direct and indirect costs and corresponding risk of developing the intangible

(a) If the subsidiary is not reimbursed and acquires no interest in the trademark → its expenditures benefit the foreign parent

(b) **Note:** if the expenditures are comparable to those incurred by independent entities in the industry → no reimbursement by the foreign parent is required under §482

(c) If the subsidiary spends significantly more than what an independent distributor would spend → an arm's length payment will be imputes from the parent to the subsidiary

(i) Imputation can be avoided by a qualified cost-sharing arrangements that is appropriate for each party's interest (Reg. §1.482-4(f)(3)(iv) Ex.2, Ex.3)

(7) Cost Sharing Agreements

(a) "*cost sharing agreement*" is an agreement under which the parties agree to share the costs of development of an intangible in proportion to their shares of reasonably anticipated benefits from exploitation of their interests in the intangible (Reg. §1.482-7(a)(1)

(i) an agreement is "*qualified*" if

(a) it includes two or more participants which expect to use the intangible in the active conduct of a trade or business

(b) "*benefits*" are based on the additional income to be generated or costs to be saved by the use of the covered intangible

(i) may be projected using input units used, produced or sold by each participant, operating profits of each participant, etc.

(ii) **Note**: if actual benefits turn out to be different than the projections → **the IRS may make an adjustment of the costs consistent with the *"commensurate with"* requirement in §482**

(iii) **Note**: NO ADJUSTMENT WILL BE MADE if the divergence of projections and actual benefits is 20% or less **OR IS DUE TO EXTRAORDIANRY EVENT BEYOND THE CONTROL OF THE PARTICIPANTS** (Reg. §1.482-7(f)(3)(iv)(B))

(c) the agreement contains certain specified information, including

(i) each participant's interst in the intangible

(ii) each participant's share of the development costs for the intangible; **AND**

(iii) the method by which costs will be determined

(ii) **IF** there is a qualified cost sharing agreement → all of the participants are considered owners of the intangible so that **NO ROYALTY PAYMENT WILL BE IMPUTED UNDER §482!**

(b) The cost-sharing Regulations

(i) Goal = that each participant's share of costs is reasonably related to the anticipated benefits

(ii) During the life of the agreement the participants make payments to each other to adjust the costs of the project to prearranged proportions

(a) The costs include all costs of general and basic research and development activities

(i) Including wages and salaries of research staff

(ii) Reasonable allowance for overhead

(c) If one of the participants to the agreement has intangibles → the other participant must make a buy-in payment at the arm's length price as compensation for use of the intangible (Reg. §1.48207(g))

(d) If a participant **LEAVES** a cost-sharing agreement → the others must make buy-out payments in proportion to the increased benefits expected from the newly acquired interest in the intangible

(8) "*Round Trip*" Transactions

(a) involve the transfer of technology to a related company which manufactures property which is sold back to the licensor for resale (see, *Bausch & Lomb, Inc. v. Comm'r* (2nd.Cir.1991)

(b) the Regulations involving "round trip" transactions treat the arm's length royalty rate separate from the arm's length price charged for the manufactured product (Reg. §1.482-5(e) Ex. 4)

(9) Loans

(a) A loan from one corporation to a related corporation must be made at arm's length or the IRS may reallocate interest income between the parties

(b) "*arm's length rate of interest*" = the rate that would be charged by unrelated parties under similar circumstances, taking into account the principal amount, duration of the loan, security involved, the credit standing of the borrower and the prevailing interest rates

(i) **Note**: if the lender charges an interest rate between 100 % and 130% of the AFR on the specified federal debt instruments → §482 does not apply! (Reg. §1.482-2(a)(2)).

D. Comparable Profits Method

1. *available to determine the arm's length price on*

a) a sale of goods

b) on the license of intangibles

2. *Methodology*

a) Method is based on the principle that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time

b) Method determines arm's length consideration for a controlled transfer of property by referring to objective measures of profitability (profit indicators) derived from uncontrolled taxpayers that engage in similar activities with other uncontrolled taxpayers

(1) "*arm's length range*" of constructive operating profits is determined by applying the profit level indicators to the tested party

(2) “*profit indicators*” are financial ratios that measure the relationships among profits, costs incurred and resources employed

(a) the **Regulations** provide a number of financial ratios that may serve as profit indicators

(i) ratio of operating profit to sales

(ii) the ratio of gross profit to operating expenses

(3) a transaction will be considered *arm’s length* **<u>IF</u>** the tested party’s actual operating profits are within the arm’s length range of the constructive operating profits

(a) “*tested party*” can be either party to a controlled transaction – but generally the one that provides the simplest and therefore most easily compared operations

(b) **Note**: in the case of a license, the **<u>licensee</u>** will generally be the tested party

E. Profit Split

*1. courts **confronted by <u>intercompany pricing issues</u>** often resort to an allocation of profits under some type of “profit split” where related corporations (e.g., Parentco and Subco) are treated as an economic unit*

a) the net profit of the unit is allocated among the members of the group consistent with their economic contributions

b) **Note**: it is often the case the courts have used a 50-50 or similar somewhat arbitrary profit split to allocate net gain between parent and subsidiary

*2. regulations = controlled taxpayer may apply the profit split method typically in situations where each controlled taxpayer owns a valuable intangible that contributes significantly to the combined profit **(or loss)** de3rived from business activities (Reg. §1.482-6)*

a) allocation of profit (or loss) is determined generally under one of two alternative methods (Reg. §1.482-6(c)(1))

(1) the comparable profit split

(a) under this method → the combined operating profit of the controlled shareholders is allocated among them in proportions derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar

(2) residual profit split

(a) under this method → two step process

(i) a market return is allocated to each controlled taxpayer on its "*routine*" contributions to the business activity

(a) a contribution is "*routine*" if similar contributions are made by uncontrolled taxpayers involved in similar business activities

(i) ex: tangible and intangible property that are of a type that are generally owned by similarly situated uncontrolled taxpayers are routine

(ii) the remainder of the operating profits is allocated in proportion to each taxpayer's nonroutine contribution

(a) if tangible or intangible property **is not similar** to that owned by similarly situated uncontrolled parties → considered *nonroutine*

(b) **Note**: the contribution of such nonroutine intangibles to the operating profit is determined based on capital costs of developing the intangible

F. The interplay of §482 and Foreign law

1. the purpose of §482 is to force taxpayers for tax purposes to deal at arm's length with related parties

2. the Regulations state that a §482 allocation may be made notwithstanding foreign legal restrictions (Reg. §1.482-1(h)(2))

a) however, a taxpayer has the right to make a deferred income election to postpone taxation until payment of the item ceases to be prevented by the foreign legal restriction **IF**

(1) the foreign restriction is widely imposed

(2) the restriction is not part of the commercial transaction between the taxpayer and the foreign government

(3) the taxpayer has exhausted its remedies in seeking a waiver

(4) the restriction has prevented payment (rather than limiting a deduction) in any form

(5) the restriction has not been circumvented in any way; **AND**

(6) the taxpayer elects a deferred income method of accounting

(7) **Note**: the IRS maintains that payment of a dividend when royalties are blocked by foreign law is a payment of the royalty in another form (*but see*, *Procter & Gamble*)

*3. **Note**: there can be no §482 where the taxpayer does not have "complete power" to shift income among its subsidiaries (Reg. §1.482-1(b)(1)*

a) See, Texaco, Inc. v. Comm'r (holding "[t]he complete lack of power referred to in the regulations hardly includes the power to force a subsidiary to violate the law [of a foreign nation]"

G. Other §482 Adjustments

1. a correlative adjustment must also be made to the income of the other related party (Reg. §1.482-1(g)(2))

2. in the domestic context such correlative adjustments usually mean an increase in the tax liability of one party and a decrease in the tax liability of the other party

*3. in the **<u>international context</u>** to the extent that the for US tax purposes (e.g., for purposes of determining the indirect foreign tax credit) the earnings and profits account of the related foreign corporation reflects the correlative adjustment*

*4. **Note**: a taxpayer can avoid a proposed adjustment under §482 in some cases by showing that it engaged in other transactions not at arm's length to their detriment (Reg. §1.482-1(g)(4) Ex. 1)*

H. Accuracy-Related Penalty

1. §6662 = if an adjustment under §482 demonstrates a "substantial valuation misstatement" a penalty equal to 20% of the adjustment is imposed

a) a "substantial valuation misstatement" occurs if

(1) the consideration reflected on the transaction in question is 200% or more, or 50% or less, of what is determined to be the arm's length price; **<u>OR</u>**

(2) the net §482 transfer price adjustment (*i.e.*, all the §482 adjustments) for the year exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts (§6662(e)(1)(B))

(3) **Note**: the penalty rate doubles 40% for a *"gross valuation misstatement*"

(a) Occurs **<u>IF</u>**

(i) The consideration is 400 percent or more, or 35% or less of the arm's length determination; **<u>OR</u>**

(ii) The net §482 transfer price adjustment exceeds the lesser of $20 million or 20% of the taxpayer's gross receipts

*2. **Note**: situations where an increase in taxable income resulting from a §482 adjustment is **<u>excluded from any net §482 adjustment</u>** (Reg. §6662-6T(d)(1))*

a) **<u>MOST SIGNIFICANT</u>**= where prices were determined by reasonable although erroneous, application of §482 pricing methods

(1) Taxpayer must have documentation that sets forth how the arm's length price was determined

I. §482 and the Foreign Tax Credit

1. adjustment may have an effect on the foreign tax credit

2. unless the foreign country recognizes the reallocation and refunds any taxes collected, the reallocation may increase US taxes without an correlative decrease in foreign taxes

a) Note: the US Co. may still be able to claim the full indirect credit under §902 <u>even on the reallocated income IF</u>

(1) The US Co. can establish that the Subco has exhausted its administrative remedies in seeking a refund of the foreign taxes on the reallocated income

(2) OTHERWISE the foreign taxes paid on the reallocated income are treated as a contribution to the foreign government not qualifying for the foreign tax credit

J. Advanced Pricing Agreements (APA)

1. IRS has procedures for them (Rev.Proc. 96-53, 1996-2 C.B. 375)

a) The APA procedure offers the certainty of pre-clearance, immunity from the IRS penalties, and it lessens the likelihood of double taxation if the relevant foreign tax authority is a party to the APA

(1) Generally →information submitted with the APA is confidential and protected by §6013.

b) Begins with taxpayer filing a request proposing a "transfer pricing methodology" (TPM) to be used in specified transactions between the taxpayer and related parties

(1) Generally must reflect a taxpayer's willingness to adhere to the arm's length pricing concept and must be efficient for the IRS to administer

(a) The transfer pricing methodology will apply to all years covered by the APA if certain *"critical assumptions*" continued to exist

(i) "*critical assumptions*" are fact(s) fundamental to the operation of the taxpayer's proposed methodology

(ii) may include

(a) facts relating to the taxpayer's business (*e.g.,* sales volume, renewal of a lease); **<u>or</u>**

(b) the industry in general (*e.g.,* number of competitors, industry growth levels)

(iii)**Note: if a critical assumption changes → the APA may provide for a "*compensating adjustment*"**

(2) Generally the IRS requires them to contain

(a) An explanation of the proposed transfer pricing methodology

(b) A description of the business operations of the taxpayer and related parties with supporting financial and tax documents

(c) An analysis of the taxpayer and the taxpayer's competitors; **<u>AND</u>**

(d) Data on the taxpayer's industry showing pricing practices and rates of return on comparable transactions between unrelated persons **<u>or</u>** if data on comparable transactions is not available → pricing data on similar transaction which may be applied with necessary adjustments to the transaction at issue

2. *APA is a <u>binding agreement</u> between the IRS and the taxpayer*

a) Applies an agreed-upon transfer pricing methodology to specified transactions between the taxpayer and a related party

b) **Note**: whenever possible the IRS will also negotiate the terms of the APA with any relevant foreign competent authorities

K. Reporting Requirements for Related Taxpayers

1. *§6038A = imposes information reporting a record keeping on any US corporation (reporting corporations) this is owned to a significant extent by a foreign shareholder and that engages in transactions with related parties*

a) **Note**: §6038C imposes similar requirements on a foreign corporation engaged in a t/b in the US

b) "reporting corporation" = generally a domestic corporation that has at least one 25% foreign shareholder or a foreign corporation engaged in a t/b in the US (Reg. §1.6038A-1(c))

c) "related party" is

(1) any 25% foreign shareholder of the reporting corporation

(2) any person related to the reporting corporation **<u>OR</u>** a 25% foreign shareholder under §267(b) or §707(b)(1)

(3) any person who is related to the reporting corporation under §482

2. Record keeping requirements for the reporting corporation - - may be required under the Regulations to keep the following records

a) Original records - - such s general ledgers, sales journals and accounting manuals

b) Profit and loss statements

c) Pricing documents - - including invoices and correspondence

d) Foreign country filings

e) Ownership and capital structure records

f) Records of loans, security agreements, litigation and other risk-shifting mechanisms

g) **Note**: these records must generally be kept in the US unless they can be produced quickly (Reg. §1.6038A-1(h))

h) **Note:** if the reporting corporation has less than $10 million in gross receipts for the taxable year **OR** satisfies the *de minimis* rule with respect to related parties → some of the record maintenance rules of §6038A do not apply (Reg. §1.6038A-1(h), (i) and (j))

3. reporting corporation must file a Form 5472 for each foreign related party with which the reporting party has a reportable transaction

a) "reportable transaction" = include

(1) salese and purchases of inventory or other tangible property

(2) rents and royalties paid or received

(3) amounts paid or received with respect to tangible property

(4) consideration or commissions paid or received for services performed

(5) amounts loaned or borrowed

(6) interest paid or received

(7) insurance premiums paid or received

(8) other amounts paid or received that affect a reporting party's taxable income (Reg. §1.6038A-2(b)(3))

(9) **Note: Fines**

(a) subjects the reporting corporation to a penalty of $10k for each year it fails to maintain records multiplied by the number of related parties for which the records are not maintained

VI. Controlled Foreign Corporations and Related Provisions

A. Overview

1. *for US taxpayers that conduct business abroad through foreign corporation → normally no US taxation* ***UNTIL*** ***and UNLESS*** *the earnings of the foreign corporation are distributed to the shareholder*

a) at that point there may be both a *direct tax credit for withholding taxes imposed on the dividend* **and** in some cases an indirect tax credit for taxes imposed on the distributing corporation's income out of which the dividend was distributed

B. Definitions : Controlled Foreign Corporation and United State Shareholder

1. *"Controlled Foreign Corporation"*

a) in order to trigger subpart F there must be a *Controlled Foreign Corporation (*CFC)

b) **Note**: a corporation that **IS NOT** a CFC is treated for tax purposes as a separate entity and is governed by the normal tax rules

c) **Definition**: foreign corporation is a CFC if → "*US shareholders*" own more than 50% of the total combined voting power of its stock or more than 50% of the stock's total value (§957(a))

d) **Definition:** "*US shareholders*" = a United States person(as defined in §957(c)) owning 10% or more of the total combined voting power of the corporate stock (§951(b))

(1) Testing whether a foreign corporation is a CFC → the Code looks to direct and indirect ownership and constructive ownership (§957(a) and §958)

(a) **Note**: when foreign partnerships or trusts own shares in foreign corporation → necessary to attribute the entity's ownership of the shares to the partners or beneficiaries

(b) **Note**: apart from **<u>indirect ownership</u>** a US person is *deemed* to constructively own stock owned by certain related persons (§958(b))

C. **Income Taxable to Shareholders**

1. *if a foreign corporation is a CFC under §957(a) for* ***<u>and uninterrupted period of 30 days or more during the taxable year</u>*** → *each US shareholder (who <u>owns stock on the last day of the year</u>) must include in income the sum of two major components*

a) the shareholder's pro rata share of subpart F income; **<u>PLUS</u>**

b) any earnings of the CFC invested in US property (§951(a))

(1) **Note**: a "*taxpayer's pro rata share of subpart F income*" is based on direct and indirect ownership (**<u>but not constructive</u>**)

(2) **Bottom line** = §951(a) treats the US shareholders as having received a current distribution out of subpart F income **<u>plus</u>** any foreign earnings invested in US property

(3) **Note**: the US shareholder is treated *as if* the shareholder received a dividend and then contributed the *deemed* dividend back to the corporation **<u>which in turn increases the shareholder's stock basis</u>** (§961)

(a) On subsequent distribution of previously taxed income → there is no further taxation **<u>ALTHOUGH THE STOCK BASIS OF THE US SHAREHOLDER MUST BE REDUCED UPON THE DISTRIBUTION</u>** (§959)

(b) **Note:** the income that is *deemed* distributed to US shareholders **may carry with it** a **<u>foreign tax credit</u>** for any creditable income foreign taxes paid (§960)

2. *Subpart F Income*

a) "Subpart F Income"

(1) **definition**: composed of several categories →

(a) income derived from insurance of US risks

(b) foreign base company income

(i) **Note**: THIS IS THE MOST IMPORTANT CATEGORY

(ii) **Definition: "***foreign base company income*" = composed of 5 categories (directed primarily at holding company structure where a US parent corporation creates a foreign subsidiary (*i.e.,* a base company) in an effort to isolate some of the income from the parent's active business in a low tax jurisdiction

(a) **Note:** the CFC provision offer a **more potent** weapon than §482 (which does allow the IRS to reallocate income entre parent and subsidiary and is equally playable)

(i) Can apply, for example, **EVEN WHEN** dealings between parent and subsidiary are at arm's length

(c) certain income from countries engaged in international boycotts

(d) and certain legal payments (§952(a))

(2) *Foreign Personal Holding Company Income*

(a) First category of foreign base company income (§954(a)(1) and §954(c))

(b) Generally consists of:

(i) Passive income such as

(a) Interest

(b) Dividends

(c) Rents

(d) Royalties

(ii) Net gains from the sale of assets producing the above income flows; or

(iii)sales of non-income producing assets; or

(iv) payments that are considered to be dividends or interest substitutes

(v) **Note**: also includes are **gains from commodities transactions or foreign currency gains**

(vi)**Note**: also includes *"income that is the equivalent of interest*"

(c) **Note**: SPECIAL RULE for interest and income derived in the active conduct of a banking or financing business

(i) *"qualified banking or financing income*" o fan eligible controlled foreign corporation will not constitute foreign personal holding income (§954(h)

(a) generally, **a an "*eligible controlled foreign corporation"* = on that is *predominately engaged in the active conduct of banking or financing***

(b) a corporation is "*predominately engaged"* if it is a licensed bank or securities dealer **OR** more than 70% of its gross income is from the active and regular conduct of alending or finance business

(c) **Note**: to avoid foreign personal holding company income → an eligible controlled foreign corporation **must earn qualified banking or financing income** which essentially is active banking or financing income derived from customers outside the US where the activities generating the income are conducted by the corporation in its **home country** (§954(h)(3))

(d)