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# A Primer on Us. Taxation of International Transactions (Outline)

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# A PRIMER ON U.S. TAXATION OF INTERNATIONAL TRANSACTIONS

By

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## **I. BACKGROUND<sup>1</sup>**

### **A. Income tax**

#### 1. Maximum rates

U.S. citizens and resident aliens are subject to maximum rates of tax as follows:

(1) On ordinary income - 35% (39.6% beginning in 2013). IRC §1.

(2) On capital gains, depending on the holding period -

(a) long term – 15% (20% beginning in 2013). IRC §§ 1(h); 1222(3); 1222(11).

(b) short term - 35% (39.6% beginning in 2013). IRC §1.

(3) On qualified dividend income – 15%. IRC § 1(h)(11). The qualified dividend tax preference expires December 31, 2012. Sec. 102(a), PL 111-312.

(4) U.S. corporations are subject to maximum rates of tax on ordinary income and capital gains of 35%. IRC § 11.

#### 2. Worldwide income is subject to tax. IRC §61.

a. Source irrelevant

b. Character irrelevant

c. Includes certain income earned by certain foreign corporations. IRC § 951(a).

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<sup>1</sup> This outline is intended as a general overview of the basic rules of U.S. tax law applicable to international transactions and investment. By its nature it is limited in scope and should not be construed to represent a comprehensive study of all of the rules, exceptions to the rules and exceptions to the exceptions that may apply to a given issue.

**B. Estate and Gift Taxation of U.S. Citizens And Domiciled Aliens**

1. Estate and Gift Tax

a. Worldwide assets subject to estate or gift tax.<sup>2</sup> IRC §§ 2031(a), 2501(a).

b. Gifts in excess of \$13,000 Per Year, Per Donee Subject to Gift Tax.  
IRC §§2501, 2503(b).

**II. Taxation of Non-Resident Aliens (“NRAs”) and Foreign Corporations Generally**

**A. Income Tax**

1. An NRA is subject to U.S. income tax only on certain limited categories of income:

a. Income effectively connected with the conduct of a U.S. trade or business (“ECI”). IRC §§ 871(b), 882(a).

b. Income that is fixed, determinable, annual or periodical (“FDAP”) that arises from U.S. sources. IRC §§ 871(a), 881.

c. Capital gains are not FDAP, but are taxable to an NRA if the NRA is physically present in U.S. for 183 days or more during the taxable year. Reg. § 1.1441-2(b)(2), IRC § 871(a)(2).

d. Gain from disposition of U.S. real property interests (“FIRPTA”). IRC § 897(a).

2. Maximum Rates

a. ECI, generally, is subject to taxation at the same rates as are applicable to a U.S. person. IRC §§ 871(b)(1), 882(a)(1).

(1) However, a foreign corporation also is subject to a branch profits tax. IRC §884.

b. U.S. source FDAP, generally, is subject to a 30% withholding tax on the gross income, unless reduced by an applicable income tax treaty. IRC §§ 871(a)(1), 881(a), 1441, 1442, 894.

c. FIRPTA gains are treated as ECI, and therefore, subject to tax at the same rates as are applicable to a U.S. person. IRC § 897(a)(1).

**B. Estate and Gift Taxes**

1. Only assets situated in the U.S. are subject to tax. IRC §§ 2103, 2511(a).

2. U.S. situs assets include:

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<sup>2</sup> Ignores the repeal of the estate tax for 2010.

ONLY)

- a. Real property located in the U.S.
- b. Shares of stock in a U.S. corporation (but taxable for estate tax purposes)
- c. Tangible personal property located in the U.S.
- d. Certain debt obligations of U.S. persons and the U.S. government (and its subdivisions, including states)
- e. Intangible property used in the U.S.

Reg. § 20.2104-1, IRC 2501(a)(2).

**C. Definitions of Non-U.S. Persons**

1. A foreign corporation is an entity treated as a corporation that is formed outside of the U.S. IRC §§ 7701(a)(3), (4) and(5).

2. A nonresident alien is an individual that is neither a citizen nor a resident of the U.S. IRC § 7701(b)(1)(B).

3. A foreign partnership is an entity treated as a partnership that is formed outside of the U.S. IRC §§ 7701(a)(2), (4) and (5).

4. A foreign trust is an entity treated as a trust that satisfies one of the following tests:

a. No court within the U.S. is able to exercise primary supervision over the administration of the trust; or

b. No U.S. person has the authority to control all substantial decisions of the trust. IRC §§ 7701(a)(31)(B), 7701(a)(30)(E).

5. A foreign estate is an estate the income of which from non-U.S. sources which is not ECI, is not includible in gross income. IRC §7701(a)(31)(A).

**D. Determination of U.S. Residence Status of Individuals**

1. Different tests apply for purposes of income tax, as compared to the estate and gift taxes.

2. For income tax purposes there are two objective tests

a. Green Card Test-If the alien is a lawful permanent resident of the U.S. under the U.S. immigration laws (holds a "green card") for any calendar year, the alien is treated as a resident of the U.S. IRC § 7701(B)(1)(A)(i).

b. Substantial Presence Test-If the alien satisfies the "substantial presence" test for any calendar year, the alien is treated as a resident. IRC § 7701(b)(1)(A)(ii). The substantial

presence test provides that if the alien is physically present in the U.S. during the calendar year for at least 31 days and was physically present in the U.S. for 183 days or more, based on a weighted formula for the current and prior two years, the alien will be treated as a resident of the U.S. IRC § 7701(B)(3)(A)(ii).

(1) The weighted formula provides the following:

- (a) Each day in the current year = 1 day
- (b) Each day in the first preceding year = 1/3 day
- (c) Each day in the second preceding year = 1/6 day.

(2) This weighting effectively limits the alien's presence to 121 days per year for three consecutive years.

c. There is an exception to the substantial presence test for an individual who is physically present for fewer than 183 days and can establish a closer connection to a foreign country in which he maintains a tax home. IRC § 7701(b)(3)(B).

3. For estate and gift tax purposes, the test is subjective. A “nonresident” decedent is a decedent who, at the time of his death, had his domicile outside the U.S. Reg. § 20.0-1(b)(2). For this purpose, domicile is the place where a person resides with intention to remain indefinitely. Reg. § 20.0-1(b)(1). This is similar to state residency tests.

#### **E. Entity Classification Rules**

1. Permit entities other than “per se” corporations to elect U.S. tax status.

a. Certain enumerated foreign entities are classified as per se corporations and therefore are not eligible to elect their tax status but instead must be classified as corporations for U.S. tax purposes. Treas. Reg. § 301.7701-2(b).

2. Entities not classified as per se corporations (“eligible entities”) can elect their tax status for federal tax purposes. Treas. Reg. § 301.7701-3(a).

3. An eligible entity with two or more members may be classified either as a corporation or a partnership. Treas. Reg. § 301.7701-3(a).

4. An eligible entity with a single owner may be classified as a corporation or a disregarded entity. Treas. Reg. § 301.7701-3(a).

5. Default Classification. Treas. Reg. § 301.7701-3(b).

a. If an entity does not elect its tax status:

(1) An eligible single member domestic entity is disregarded and an eligible multiple member domestic entity is classified as a partnership.

(2) An eligible single member foreign entity is classified as a disregarded entity if the member does not have limited liability but as a corporation if the member has limited liability.

(3) An eligible multiple member foreign entity is classified as a partnership if any one of the members does not have limited liability but as a corporation if all of the members have limited liability.

### **III. Source Rules**

#### **A. In general**

1. The source rules determine whether income is U.S. or non-U.S. source.
2. The source rules depend on character of income to determine the source

#### **B. Interest**

1. In general, interest is sourced based upon the residence of payor. IRC §§ 861(a)(1), 862(a)(1).
2. However, interest on deposit in foreign branch of U.S. bank is treated as foreign source income. IRC § 861(a)(1)(A)(i).

#### **C. Dividends**

1. In general, dividends are sourced based upon the place of incorporation of payor. IRC §§ 861(a)(2), 862(a)(2).

#### **D. Royalties**

1. Royalties are sourced based upon the place of use of the intangible property that gives rise to the royalties. IRC §§ 861(a)(4), 862(a)(4).

#### **E. Rents**

1. Rents are sourced based upon the place of use of the tangible property gives rise to the rents. IRC §§ 861(a)(4), 862(a)(4).

#### **F. Salaries/Wages**

1. Compensation for labor or personal services is sourced based upon the place of performance of the labor or personal services. IRC §§ 861(a)(3), 862(a)(3), 863(b)(1).

#### **G. Inventory**

1. There are special source rules governing income from the sale of inventory by nonresidents and foreign corporations.
  - a. If title passes to the goods in the U.S., the income is U.S. source. IRC §§ 865(b), 861(a)(6).

b. If title passes to the goods outside the U.S., the income, in general, is foreign source. IRC §§ 865(b), 862(a)(6). However, even if title passes to the goods outside the U.S., if the sale is “attributable to” a U.S. office or other fixed place of business of the taxpayer, the income will be U.S. source income unless a foreign office of the taxpayer materially participates in the sale and the goods are sold for use, disposition or consumption outside the U.S. IRC §§ 865(e)(2). For this purpose, a sale is attributable to a U.S. office if:

(1) The U.S. office is a “material factor” in the production of the income; and

(2) The U.S. office regularly carries on such business activities.  
IRC §§ 865(e)(3), 864(c)(5).

2. Income from the sale of inventory property that is produced within the U.S. and sold without the U.S. or that is produce without the U.S. and sold within the U.S. is sourced partly within and partly without the U.S. in accordance with regulations issued by the Secretary. IRC § 863(b)(2).

#### **IV. Taxation of Effectively Connected Income**

##### **A. U.S. Trade or Business**

1. In order to have ECI, a foreign person must be engaged in the conduct of a trade or business with the U.S. (“USTB”). IRC § 864(c)(1)(A).

2. However, the conduct of a USTB is not defined in the IRC except to state that it includes the performance of personal services in the U.S. IRC § 864(b).

3. The determination is based on a facts and circumstances test. Rev. Rul. 88-3, 1988-1 CB 268.

4. However, it generally requires regular and continuous activity in the U.S. European Naval Stores Co., S. A., 11 T.C. 127 (1948).

5. Whether a foreign person is engaged in the conduct of a USTB (“ETB”) is determined on annual basis. IRC § 864(c)(1)(A).

6. A foreign person may engage in a USTB directly or indirectly, including through a branch, or as a partner in partnership that itself is ETB. IRC § 875.

7. There are two statutory USTB exceptions:

a. De Minimis services-The performance of personal services by an NRA temporarily present in the U.S. for a period not exceeding 90 days during the year for a foreign person that is not ETB, or a domestic person that maintains an office or fixed place of business outside the U.S., provided the NRA's aggregate compensation for such services does not exceed \$3,000 is not considered to be USTB by such NRA. IRC § 864(b)(1).

b. Securities and commodities traders are subject to an exception, which if met, treats certain activities as not rising to the level of a USTB. IRC § 864(b)(2). Under this exception, a USTB does not include:

(1) Trading in stocks, securities or commodities through independent broker. IRC §§ 864(B)(2)(A)(i), 864(b)(2)(B)(i). However, this exception is not available if the taxpayer's U.S. office participates in effecting transaction. IRC § 864(b)(2)(C).

(2) Trading for the taxpayer's own account, unless the taxpayer is a dealer in stocks, securities or commodities. IRC §§ 864(b)(2)(A)(ii), 864(b)(2)(B)(ii).

**B. Determining if Gross Income is Effectively Connected Income**

1. The rules differ depending on whether the income being tested is U.S. or foreign source income. IRC §864(c)(2), (3) and (4).

a. If the income is *U.S.* source income, the rules differ depending upon whether the income is

(1) FDAP-type income. IRC § 864(c)(2).

(2) Other income. IRC § 864(c)(3).

b. If the income is *foreign* source income, only specified types are ECI. IRC § 864(c)(4).

2. U.S. source FDAP income is ECI if it satisfies either an asset use test or a material factor tests. IRC § 864(c)(2).

a. Under the asset use test, income that otherwise would be FDAP which is derived from assets used in the conduct of a USTB will be treated as ECI, and not as FDAP. IRC § 864(c)(2)(A).

b. Under the material factor test, income that otherwise would be FDAP will be treated as ECI if the activities of the USTB were a material factor in the realization of income. IRC § 864(c)(2)(B).

3. Any U.S. source income, other than FDAP type income is treated as ECI. IRC § 864(c)(3). This rule is known as the "unlimited force of attraction rule." Thus, if a foreign person is ETB, all of its U.S. source non-FDAP type income is ECI, whether such income is related to the USTB or not.

4. Foreign source income generally is not ECI. IRC 864(c)(4)(A). However, foreign source income will be treated as ECI if:

a. The foreign person maintains U.S. office or other fixed place of business ("FPB"); and

b. The foreign source income consists of :

(1) Certain rents or royalties

- (2) Certain dividends and interest;
- (3) Certain gains or losses from sales of inventory-type property
- (4) Economic “equivalent” of such income

IRC § 864(c)(4)(B).

**C. Effectively Connected Deductions and Credits**

1. Deductions and credits are allocated and apportioned to ECI in order to arrive at taxable income. Reg. § 1.861-8.

a. Special rules for apply of the allocation and apportionment of interest. Reg. § 1.882-5.

2. Deductions and credits are allowed only if a tax return is timely filed. Reg. § 1.882-4. Swallows Holding, Ltd. V. Commissioner, 515 F. 3d 162 ( 3<sup>rd</sup> Cir. 2008).

**V. Taxation of U.S. Source FDAP Income**

**A. 30% Tax on Gross Income**

1. Unlike ECI, which is taxed at graduated rates on the net taxable income, U.S. source FDAP income is subject to a flat 30% tax which is collected by withholding. IRC §§ 871(a)(1), 881(a), 1441, 1442.

2. However, the tax and withholding may be reduced or eliminated by treaty. IRC §894.

3. Only U.S. source FDAP income is subject to tax.

**B. What is FDAP Income?**

1. Definition: Income is FDAP if it is interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other FDAP. IRC §§ 871(a)(1)(A), 881(a)(1).

a. Fixed – paid in amounts definitely predetermined

b. Determinable – basis by which amount to be paid may be ascertained

c. Annual – paid on same date every year

d. Periodical – paid from time to time, whether or not at regular intervals.

Reg. §1.1441-2(b)(1).

2. Effectively FDAP is any income other than income from sale or exchange of property. Reg. §1.1441-2(b)(2)(i).

3. Income that otherwise would be FDAP income may be ECI instead if either the Asset-Use Test or the Material Factor Test is satisfied. IRC § 864(c)(2).

4. Rents which otherwise would be FDAP are eligible for an election to treat rental income as ECI. §§ 871(d), 882(d)

**C. Tax Exemptions for U.S. Source Interest**

1. There are 3 major exemptions for U.S. source interest, which although the interest is U.S. source and FDAP, it is exempt from U.S. taxation and withholding if any one of the exemptions is satisfied, provided the interest income is not ECI.

a. Portfolio interest. IRC §§ 871(h), 881(c).

b. Bank deposit interest. IRC §§ 871(i)(2), 881(d).

c. Short-term original issue discount obligations. IRC § 871(g).

2. Interest is exempt from withholding and taxation as FDAP if it is derived from a portfolio interest obligation. IRC §§ 871(h)(2), 881(c)(2).

a. A portfolio interest obligation is either:

(1) A bearer obligation arranged to ensure that only non-U.S. persons will hold<sup>3</sup>, or

(2) A registered obligation where the U.S. payor has received a statement (Form W-8BEN) that beneficial owner is not a U.S. person.

b. There are several exceptions to the portfolio interest exemption.

(1) If the interest is received by a 10% shareholder of a corporate payor or a 10% partner of a partnership payor, the interest is not treated as portfolio interest. IRC §§ 871(h)(3), 881(c)(3)(B).

(2) If the interest is contingent on the income, profits, change in value or similar criteria of the payor, the interest is not treated as portfolio interest. IRC §§ 871(h)(4), 881(c)(4).

(3) If the recipient of the interest is a foreign bank and the interest is paid with respect to a loan made in the ordinary course of the bank's trade or business, the interest is not portfolio interest. IRC § 881(c)(3)(A).

(4) If the recipient is a "controlled foreign corporation" and payor is a related person to the CFC, the interest is not treated as portfolio interest. IRC § 881(c)(3)(C).

3. Bank deposit interest is exempt from FDAP taxation. IRC §§ 871(i)(2), 881(d).

4. Interest on short-term original issue discount obligations is exempt from FDAP taxation. IRC § 871(g).

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<sup>3</sup> Repealed by FATCA for instruments issued after March 12, 2012.

a. For this purpose, short term means an obligation due 183 days or less from date of issue. IRC § 871(g)(1)(B)(i).

b. However, taxpayers should be aware of a rollover problem, if short term original issue discount obligations are continuously reissued to the same holder.

## VI. Withholding

### A. Types of Withholding

1. U.S. source FDAP income.
2. U.S. source services income.
3. Foreign partner's share of partnership income.
4. Disposition of United States real property interest ("USRPI").
5. Foreign Asset Tax Compliance Act ("FATCA").

### B. U.S. Source FDAP Withholding

1. No withholding is required unless the income is U.S. source. IRC §§ 1441, 1442.
2. If the FDAP is U.S. source, withholding is required at a 30% rate unless an exemption is available and the payor receives an appropriate Form W-8 from the beneficial owner or intermediary

a. Form W-8BEN

b. Form W-8ECI

c. Form W-8IMY

### C. Foreign Account Tax Compliance Act ("FATCA") Provisions of HIRE Act

1. FATCA added a new "Chapter 4" with its own withholding requirements: Sections 1471 – 1474.

2. Basic Concept: Any payor of U.S. source FDAP **or gross proceeds** related to U.S. source FDAP securities (defined as "withholdable payments") must withhold 30% from such amount paid to a non-U.S. payee UNLESS the payee agrees to provide information on its U.S. customers or owners. IRC § 1471(a).

3. These rules will apply not just to financial institutions but to all U.S. payors. IRC 1473(4).

4. All withholding agents must apply Chapter 4 before applying the current FDAP withholding rules. IRC § 1474(d).

5. Effective for payments made after December 31, 2012 (subject to certain grandfathering rules). Notice 2011-53, 2011-32 I.R.B. 124, extends the effective dates for certain payments either one or two years.

**D. Service Income Withholding**

1. If paid to a foreign corporation, generally, no withholding is required because the income is ECI. IRC §§1442(a), 1441(c)(1).

2. If paid to a nonresident alien, the type of withholding depends on the relationship of the service provider to the service recipient.

a. If the service provider is an independent contractor, 30% FDAP withholding is required. IRC § 1441.

b. If the service provider is an employee, regular employee withholding is required. IRC § 3401.

**E. Withholding by Partnership**

1. A domestic partnership must withhold with respect to its foreign partners with respect to certain categories of income.

a. To the extent that the domestic partnership makes distributions treated as U.S. source FDAP income, the domestic partnership must withhold 30% of such amount. Reg. § 1.1441-3(f).

b. To the extent of a foreign partner's distributive share of U.S. source FDAP income, the domestic partnership must withhold 30% of such amount. Reg. § 1.1441-3(f).

c. To the extent of a foreign partner's distributive share of the domestic partnership's ECI, the domestic partnership must withhold at the highest rate applicable to such income. IRC § 1446.

2. A foreign partnership must withhold only with respect to a foreign partner's distributive share of the foreign partnership's ECI. IRC § 1446.

**F. Reporting Obligations**

1. The payor must file Forms 1042 and 1042S with respect to amounts of U.S. source paid to foreign persons.

2. A foreign persons is required to file an income tax return in limited circumstances (Forms 1040NR, 1120F)

a. If the foreign person is engaged in a USTB, it must file an income tax return. Reg. §§ 1.6012-1(b)(1)(i), 1.6012-1(g)(1)(i).

b. If a foreign person does not file a timely return, it will lose all deductions. Reg. §§ 1.874-1(a), 1.882-4(a)(2).

c. If a foreign person is not engaged in a USTB and all of its U.S. tax liability is satisfied through withholding, no tax return is required. Reg. §§ 1.6012-1(b)(2)(i), 1.6012-1(g)(2)(i).

## **VII. FIRPTA**

### **A. FIRPTA: Foreign Investment in U.S. Real Property Tax Act -In General**

1. Gain from disposition of U.S. real property interest (“USRPI”) is treated as ECI. IRC § 897(A)(1).

2. A USRPI includes any interest, except solely as a creditor :

a. That is a direct interest in U.S. real property , or

b. Stock in a domestic U.S. real property holding corporation (“USRPHC”). IRC §897(c)(1), Reg. § 1.897-1(c)(1).

3. A U.S. Real Property Holding Corporation is any corporation if within the 5 year period ending on the date of disposition:

a. The fair market value of its USRPIs was at least 50% of the sum of the fair market values of:

(1) its USRPIs

(2) its real property interests outside the U.S.

(3) other trade or business assets. IRC § 897(c)(2).

b. Publicly traded stock is considered stock in a USRPHC only in the case of a person who held more than 5% during the 5 year period ending on the date of disposition. IRC §897(c)(3).

### **B. FIRPTA Withholding**

1. The transferee must withhold 10% of the amount realized on disposition of USRPI by a foreign person. IRC § 1445.

2. There are limited exemptions available.

a. If the transferor provides a non-foreign affidavit. Reg. § 1.1445-2(b)(2).

b. The transferee receives non-USRPHC affidavit with respect to stock it acquires. Reg. § 1.1445-2(c)(3).

c. The transferee receives a qualifying statement from the IRS that reduces or eliminates the withholding obligation. Reg. § 1.1445-3.

d. The transferee will use the USRPI as a residence and the amount realized by the transferor does not exceed \$300,000. Reg. § 1.1445-2(d)(1).

e. No withholding is required with respect to a disposition of shares of a class of stock that is traded on an established securities market. IRC § 1445(b)(6).

## **VIII. Treaties**

### **A. In General**

1. The provisions of a treaty may modify the statutory rules of taxation. IRC § 894.
2. To claim treaty benefits a person must be:
  - a. A “resident” of treaty country as that term is defined in the applicable treaty; and
  - b. Satisfy the treaty’s limitation on benefits provision.<sup>4</sup>

### **B. Treaty Benefits for ECI**

1. Typically, a tax treaty provides that the U.S. may not tax business profits of a foreign person unless that person maintains a “permanent establishment” in US.
2. Maintaining a permanent establishment requires a higher threshold of activity than is necessary to be ETB. Treaties generally provide that preparatory or auxiliary activities do not constitute permanent establishment.
3. Only ECI type income attributable to a permanent establishment is subject tax. This overrides the force of attraction principle that, in general, causes all U.S. source income to be ECI if a foreign person is ETB.

### **C. Treaty Benefits for FDAP**

1. In general, treaties reduce or eliminate U.S. tax on U.S. source FDAP of a foreign person.
  - a. For example, interest and royalties often have rates that may be reduced to 0%.
  - b. Frequently, dividends are subject to withholding at rates ranging from 5%-15%.
    - (1) Some newer treaties have a 0% rate on dividends.
    - (2) In general, the lowest rates applicable to dividends apply to intercorporate dividends with certain minimum stock ownership thresholds.

2. To claim the benefits of reduced or eliminated withholding on U.S. source FDAP, the recipient must provide Form W-8 BEN: Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding.

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<sup>4</sup> A small number of typically older tax treaties to which the U.S. is a party do not contain a limitations on benefits provision.

## **IX. Foreign Tax Credit**

### **A. In General**

1. The U.S. gives a credit against U.S. tax liability for foreign taxes paid by a taxpayer. IRC § 901.

2. The credit is available for foreign taxes paid directly by the taxpayer and, in the case of a C corporation taxpayer, for certain foreign taxes paid by a foreign corporation in which the C corporation meets certain ownership requirements. This is known as "Deemed Paid" foreign taxes. IRC § 902.

3. Only certain taxes, those based on net income in the U.S. sense, are eligible for the foreign tax credit. Reg. §§ 1.901-2(a)(1), 1.901-2(a)(3).

4. The foreign tax credit is limited to the U.S. tax on the taxpayer's net foreign source income. IRC §904(a).

5. The foreign tax credit limitation is determined separately for various categories of income. IRC § 904(d).

### **B. Deemed Paid Foreign Taxes**

1. A U.S. C corporation is deemed to have paid a share of the foreign taxes paid by a 10% owned foreign corporation when:

- a. It receives a dividend from the foreign corporation. IRC § 902(a).
- b. It includes income or earnings of the foreign corporation under subpart F. IRC § 960.
- c. It recognizes gain on the sale of stock of a CFC. IRC §§ 1248, 902(a).

2. Taxes deemed paid are determined by reference to the portion of the foreign corporation's earnings and profits included by the U.S. corporation.

### **C. Separate Baskets**

1. The foreign tax credit limitation used to be applied separately to each of nine categories (baskets).

2. For for post 2006 tax years there are only 2 baskets:

- a. Passive category income
- b. General category income. IRC § 904(d)(1).

## **X. SUBPART F**

### **A. Basic Rules of Subpart F**

1. Certain income of a controlled foreign corporation ("CFC") is includible in the income of its "U.S. shareholders" in the year earned by the CFC . IRC § 951(a)(1)(A)(i).

2. Earnings of a CFC which are invested in U.S. property are treated as taxable to its U.S. shareholders. IRC § 951(a)(1)(B).

3. Ordering rules eliminate double inclusions of income taxed under the above rules when the CFC makes distributions to its shareholders. IRC § 959.

4. A U.S. Shareholder's basis in the stock of the CFC is adjusted for inclusions of income and distributions of nontaxable previously taxed income. IRC § 961.

5. A C corporation U.S. Shareholder is deemed to have paid its proportionate share of the foreign taxes paid by the CFC. IRC § 960.

**B. Definitions of Controlled Foreign Corporations ("CFC") and United States Shareholder**

1. A CFC is a foreign corporation more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of the stock is owned directly, indirectly, or constructively by U.S. shareholders on any day during the taxable year of such corporation. IRC § 957(a).

2. A United States shareholder for this purpose is any U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. IRC § 951(b).

3. Specific stock ownership rules apply to determine both U.S. shareholder and CFC status.

a. There are three types of stock ownership:

(1) Stock owned directly. IRC § 958(a)(1)(A).

(2) Stock owned indirectly, which for this purpose is stock owned proportionately through all foreign entities. IRC § 958(a)(2).

(3) Stock owned constructively which utilizes the constructive ownership rules of IRC § 318 with certain modifications. IRC § 958(b).

(a) There is no attribution from a non-U.S. individual to a U.S. individual under the family attribution rules. IRC § 958(b)(1).

(b) If an entity owns more than 50% of a corporation it is treated as owning 100% of the corporation. IRC § 958(b)(2).

(c) Stock owned by a corporation will be proportionately attributed to a 10% or greater shareholder, rather than a 50% or greater shareholder. IRC § 958(b)(3).

(d) There is no attribution from a non-U.S. partner, beneficiary or shareholder of a partnership, estate or trust, or corporation, respectively, to such a U.S. partnership, estate or trust, or corporation. IRC § 958(b)(4).

b. These rules also apply to determine which persons are treated as related persons with respect to a CFC. IRC § 958(b).

**C. Taxation of U.S. Shareholders of a CFC**

1. A U.S. shareholder of a CFC on the last day of the CFC's taxable year during which it was a CFC for an uninterrupted period of 30 days or more must include in gross income its pro rata share of the CFC's:

- a. subpart F income;
- b. previously excluded Subpart F income withdrawn from less developed countries;
- c. previously excluded Subpart F income withdrawn from shipping operations; and
- d. increase in earnings invested in U.S. property. IRC § 957(a)(1).

2. The subpart F inclusion “hopscoches” over intervening foreign corporations.

a. The U.S. shareholder’s pro rata share is the amount that would have been distributed with respect to the stock owned by the shareholder, directly or indirectly. IRC §§ 957(a)(2), 958(a).

**D. Subpart F Income**

1. Subpart F Income is defined in IRC § 952(a) to be the sum of:

- a. Certain income derived from the insurance of risks determined under IRC § 953;
- b. “Foreign Base Company Income” (determined under IRC § 954);
- c. Boycott income (determined under IRC §§ 952(a)(3) and 999);
- d. Certain illegal bribes and kickbacks (determined under IRC §§ 162(c) and 952(a)(4); and
- e. Income from unrecognized foreign countries (determined under IRC §§ 901(j) and 952(a)(5)).

2. Foreign Base Company Income (“FBCI”) is the largest and therefore the most significant category of Subpart F income. It is defined by IRC § 954(a) to mean the sum of:

- a. Foreign Personal Holding Company Income;
- b. Foreign Base Company Sales Income;

- c. Foreign Base Company Services Income;
- d. Foreign Base Company Oil Related Income.

**E. Foreign Personal Holding Company Income (“FPHCI”)**

1. FPHCI is defined by IRC § 954(c)(1) to include:

- a. Dividends, interest, royalties, rents and annuities. IRC §954(c)(1)(A).
- b. Net gains from the sale of property which either:
  - (1) generates passive types of income listed in 1 above.
  - (2) is an interest in a trust, partnership or REMIC, or
  - (3) generates no income. IRC § 954(c) (1)(B).
- c. Net gains from commodity transactions except
  - (1) Bona fide hedging transactions
  - (2) Active business gains from the sale of commodities. IRC § 954(c) (1)(C).
- d. Net foreign currency gains, (except directly related to the business needs of the CFC.) IRC § 954(c) (1)(D).
- e. Income equivalent to interest. IRC §954(c)(1)(E).
- f. Net income from notional principal contracts (except to hedge inventory property). IRC §954(c)(1)(F).
- g. Certain payments in lieu of dividends under equity securities agreements. IRC §954(c)(1)(G).
- h. Income from certain personal service contracts. IRC §954(c)(1)(H).

2. Certain types of income that would otherwise constitute FPHCI are excluded.

- a. Active trade or business rents and royalties received from an unrelated person. IRC § 954(c)(2)(A).
- b. Export financing interest. IRC §§ 954(c)(2)(B), 904(d)(2).
- c. Same country related person dividends and interest. IRC § 954(c)(3)(A).
- d. Special rules for active banking, financing or similar business. IRC § 954(h).
- e. Special rules for investment income of certain insurance companies. IRC § 954(i).

3. IRC § 954(c)(6) provides a look through rule for certain payments received by a CFC from related CFCs.

- a. Enacted by Tax Increase Prevention and Reconciliation Act 2005
- b. Dividends, interest, rents, and royalties received from a related CFC are not treated as FPHCI to the extent attributable to non-Subpart F income of the related CFC.
- c. Applicable to tax years of CFCs beginning after 2005 and before 2012. P.L. 111-312, § 751(a).

**F. Foreign Base Company Sales Income (“FBCSI”)**

1. FBCSI is defined by IRC § 954(d)(1) to mean income in the form of profits, commissions, fees or otherwise derived by a CFC in connection with a purchase/sale of personal property with a related person, but only if the goods originate outside of and are used outside of the CFC’s country of incorporation.

2. The related person requirement can arise in any of the following FBCSI type transactions

- a. The purchase of personal property from a related person and subsequent sale to any person;
- b. The purchase of personal property from any person and subsequent sale to a related person;
- c. The purchase of personal property from any person on behalf of a related person; or
- d. The sale of personal property to any person on behalf of a related person.

3. For this purpose, a person is related to a CFC if:

(1) Such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the CFC; or

(2) Such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the CFC. IRC § 954(d)(3).

4. Control, for this purpose means the ownership of:

- a. More than 50% of the vote or value of the stock of a corporation.
- b. More than 50% of the value of the beneficial interests in a partnership, trust, or estate. IRC § 954(d)(3).

5. The geographic requirement for FBCSI will be satisfied only if:

- a. The property is manufactured, produced, grown, or extracted outside the country of organization of the CFC; and

b. The property is sold for use, consumption, or disposition outside the country of organization of the CFC. IRC § 954(d)(1)(A) and (B).

6. If a CFC is a manufacturer of the property, the place of manufacture and use are not relevant, and a transaction with related person does not trigger FBCSI. Reg. § 1.954-3(a)(4)(i).

a. A CFC will be considered to have manufactured property only if it satisfies one of the three following tests:

- (1) Substantial Transformation
- (2) Substantial Operations-Generally Considered Manufacturing
- (3) Contract Manufacturing. Reg. § 1.954-3(a)(4)(i).

b. Substantial Transformation-If personal property purchased by the CFC is substantially transformed by it prior to sale, the property sold will be considered manufactured by the CFC. Reg. § 1.954-3(a)(4)(ii). The regulation contains three examples of Substantial Transformation:

- (1) Conversion of wood pulp to paper
- (2) The machining of steel rods to screws and bolts
- (3) The processing of raw tuna fish into canned fish.

c. Substantial Operations-Generally Considered Manufacturing-If purchased property is a component part of property sold by the CFC and the operations of the CFC are substantial in nature and generally considered to constitute manufacture, production, or construction, the property sold will be considered a manufactured product rather than the sale of the component parts. Reg. § 1.954-3(a)(4)(iii).

(1) This is a subjective test that requires a determination of whether the operations are "generally considered" to constitute manufacture, production or construction. See, Garnac Grain Co. v. Commissioner, 95 T.C. 7 (1990).

(2) However, there is a presumption that if the CFC's conversion costs (direct labor and factory burden) are at least 20% of the total costs of goods with respect to the product, the product will be considered to be manufactured. Reg. § 1.954-3(a)(4)(iii).

d. Contract Manufacturing-On December 24, 2008 Treasury issued final regulations under IRC § 954(d) which that in certain contract manufacturing arrangements, the CFC will be considered to have manufactured property even though another person, related or unrelated, has performed the actual physical manufacturing functions. Reg. § 1.954-3(a)(4)(iv)(a).

(1) For CFC to be considered a manufacturer, it must make a substantial contribution to the manufacturing process through the activities of its own employees

(2) The regulation contains a nonexclusive list of seven factors that will be considered in determining whether the CFC makes a substantial contribution to the manufacture through its own employees. Reg. § 1.954-3(a)(4)(iv)(b).

7. The FBCSI provisions include a "Branch Rule" under IRC § 954(d)(2) that treats a branch of CFC as separate corporation for FBCSI purposes if the income of branch is taxed at an effective tax rate that is less than 90% and 5 percentage points less than the effective tax rate that would apply in the CFC's country of incorporation to the income earned by the branch and not taxed in the CFC's country of incorporation. Reg. § 1.954-3(b).

**G. Foreign Base Company Services Income ("FBCSEI")**

1. FBCSEI is income in the form of compensation, commissions, fees, etc. derived in connection with the performance of services performed for or on behalf of any related person, and performed outside the country of organization of the CFC. IRC § 954(e)(1).

2. Performance of services for or on behalf of a related person includes services where:

a. The CFC is paid by, released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing the services.

b. The services are services which a related person is or was obligated to perform.

c. The performance of the services is a condition or material term of a sale of property by a related person.

d. Substantial assistance in the performance of the services by the CFC has been furnished by related person. Reg. § 1.954-4(b)(1).

3. Substantial Assistance provided by a related person is determined as follows:

a. Assistance includes direction, supervision, services, know-how, financial assistance (other than capital contributions) equipment, material or supplies. Reg. § 1.954-4(b)(2)(ii)(a).

b. Assistance is substantial if:

(1) It provides the CFC with skills that are principal element in producing services income; or

(2) The cost to the CFC equals 50% or more of total cost to CFC of performing its services. Reg. § 1.954-4(b)(2)(ii)(b).

c. However, under Notice 2007-13, 2007-5 I.R.B. 410, only applicable to assistance from a U.S. related person counts and it is substantial only if the cost to the CFC equals 80% - not 50% - under the above test.

**H. Exclusions From and Limitations on Subpart F Income**

1. De minimis/Full Inclusion rules for FBCI. IRC §§ 954(b)(3)(A) and (B).

2. Deductions from Gross FBCI. IRC §§ 954(b)(5).

3. High-Tax Exception. IRC §§ 954(b)(4).

4. Exclusion of Effectively Connected Income. IRC §§ 952(b).
5. E&P Limit on Subpart F Income. IRC § 952(c)(1)(A).

**I. Investment of Earnings in United States Property**

1. U.S. shareholders of a CFC are taxed on their pro rata share of CFC's increase in earnings invested in United States property. IRC § 951(a)(1)(B). The amount is determined under IRC § 956, and thus is known as the "Section 956 inclusion."

2. The Section 956 Inclusion is:

a. the **lesser** of

- (1) U.S. shareholder's pro rata share of CFC's U.S. property and
- (2) U.S. shareholder's pro rata share of the CFC's current and accumulated E&P ("applicable earnings"). IRC § 956(a).
- (3) The amount of U.S. property is the average of amounts of U.S. property held at the end of each quarter of the CFC's taxable year. IRC § 956(a)(1)(A).

3. For purposes of the Section 956 Inclusion, United States property is defined by IRC § 956(c)(1) as any of the following:

- a. Tangible property located in the United States.
- b. Stock of a domestic corporation.
- c. An obligation of a United States person.
  - (1) For this purpose the guarantee of an obligation of a U.S. person by a CFC is treated as if the CFC held the obligation of the U.S. person. Reg. § 1.956-2(c)(1).
  - (2) The CFC is treated as guaranteeing the obligation of a U.S. shareholder who pledges at least 2/3 of the stock of the CFC. Reg. § 1.956-2(c)(2).
- d. The right to the use intellectual property in the United States.
- e. A trade or service receivable acquired from a related U.S. person if the obligor is a U.S. person.

4. However, under IRC § 956(c)(2), certain items are excluded from the definition of United States property for purposes of the Section 956 Inclusion. These are:

- a. Obligations of the United States and money and bank deposits.
- b. Property located in the U.S. which is purchased in the U.S. for export to, or use in, foreign countries.
- c. An ordinary obligation of a U.S. person arising in connection with the sale of property.

- d. A service receivable paid within 60 days.
- e. An obligation held at the end of the CFC's taxable year, if collected within 30 days from the time it is incurred.
- f. Certain transportation equipment used in foreign commerce, predominantly outside the United States.
- g. Insurance company assets (equivalent to an amount of unearned premiums or reserves, which are ordinary and necessary for the proper conduct of its insurance business attributable to certain insurance contracts).
- h. Stock or obligations of a domestic corporation which is not a U.S. shareholder of the CFC, or which is not 25% or more owned by such U.S. shareholders.
- i. Movable property other than a vessel or aircraft used on the Continental Shelf of the U.S. Section.
- j. An amount of assets of the CFC equal to its U.S. source effectively connected income.
- k. Property which is held by FSC and which is related to the export activities of such FSC.
- l. Deposits of cash or securities received by a dealer as collateral with respect to a loan or other financial transaction.
- m. Obligation of a U.S. person obtained by a dealer with respect to a "repo" agreement.
- n. Securities held by a securities dealer in ordinary course of its business.
- o. An obligation of a U.S. person that is not a corporation and is not a U.S. Shareholder of the CFC or a related person to the CFC.

**J. IRC § 1248**

- 1. IRC § 1248 is not part of Subpart F, but acts as a backstop to it.
- 2. IRC § 1248 provides that a U.S. shareholder of CFC converts its capital gain on sale of the shares it owns in a CFC to dividend income to extent of CFC's accumulated E&P (other than PTI). IRC § 1248(a).
- 3. For corporate U.S. shareholders, the consequences of such conversion are as follows:
  - a. No tax rate differential for dividend income vs. long term capital gains
  - b. Deemed paid foreign tax credit for the CFC's foreign taxes is available because of the dividend treatment.

c. Loss of ability to utilize capital losses to extent they exceed remaining capital gain.

4. For individual U.S. shareholders, the consequences of such conversion depend upon whether the CFC is a “qualified foreign corporation”

a. If yes, no rate differential between the "qualified dividend" and the long term capital gain.

b. If no, there is a rate differential (35% vs. 15%).

c. Loss of ability to utilize capital losses to extent they exceed remaining capital gain.

## **XI. Passive Foreign Investment Company Rules**

### **A. Definition of a PFIC**

1. A PFIC is a foreign corporation that satisfies either:

a. The passive income test; or

b. The passive asset test. IRC § 1297(a).

2. Unlike subpart F, there is no stock ownership threshold.

3. Attribution rules apply do apply for determining if a U.S. person owns stock in a PFIC. IRC § 1298(a).

### **B. PFIC Income and Asset Tests**

1. The passive income test provides that a foreign corporation will be a PFIC if 75% or more of its gross income for a taxable year is passive income. IRC § 1297(a)(1).

2. The passive asset test provides that a foreign corporation will be a PFIC if the quarterly average percentage of its assets for a taxable year which are passive assets is 50% or more. IRC § 1297(a)(2).

3. For purposes of both tests, there is a look through rule which provides that if a foreign corporation owns 25% of another foreign corporation the owner is treated as if it held its proportionate share of the assets of the lower tier corporation and as if it earned its proportionate share of the income earned by the lower tier corporation. IRC § 1297(c).

a. This look through only operates to one way, attributing from the lower tier corporation to the upper tier corporation, and not vice versa.

### **C. Passive Income and Assets**

1. For PFIC purposes, in general, passive income is FPHC income as defined for subpart F purposes. IRC § 1297(b)(1).

2. However, there are special exceptions under the PFIC rules for

- a. Banking and insurance businesses
  - b. Interest, dividend, rent or royalty from 25% owned entity
  - c. Foreign trade income. IRC § 1297(b)(2).
3. For PFIC purposes, passive assets are assets which
- a. produce passive income or
  - b. are held for the production of passive income. IRC § 1297(a)(2).

**D. Tax Consequences of PFIC Status**

1. There are three alternative regimes that determine the tax consequences to the U.S. person that is a shareholder of a PFIC.

- a. Excess Distribution Regime (Default Rule)
- b. Qualified Electing Fund Regime (“QEF”)
- c. Mark-to-Market Regime

2. The Excess Distribution Regime imposes a tax liability and a deferred interest charge upon a U.S. person that receives an excess distribution from a PFIC. IRC § 1291(a)(1).

a. An excess distribution for this purpose is the sum of:

(1) Any distribution in respect of the stock of the PFIC that exceeds 125% of a 3-year moving average; plus

(2) ANY gain on actual or constructive disposition of the stock.  
IRC §§ 1291(b)(1), 1291(a)(2).

b. The excess distribution is spread across the taxpayer's post-1986 holding period. IRC § 1291(a)(1)(A).

c. Tax for each year is computed at the highest rate applicable to ordinary income. IRC §§ 1291(a)(1)(B), IRC § 1291(c)(2).

d. An underpayment interest rate to each such tax amount determined with respect to all years other than the current year and pre-1987 years. IRC § 1291(c)(3).

e. The taxpayer's total tax liability is determined by adding up the preceding results. IRC § 1291(a)(1).

f. Because the excess distribution includes gain from disposition of PFIC shares and is treated as ordinary income, there is a loss of the long term capital gain preference.

g. No stepped-up basis at death for shares in a PFIC inherited from a U.S. person . IRC § 1291(e).

3. Under the QEF Regime, the taxpayer may make an election to include each year its share of the PFIC's ordinary earnings as ordinary income and net capital gain as long term capital gain. IRC § 1293(a)(1).

a. The taxpayer may make the election to treat the PFIC as a QEF, provided that the PFIC complies with requirements to provide information to the taxpayer annually so that the taxpayer can report its share of the PFIC's ordinary earnings and net capital gain. IRC § 1295(a)(2).

b. The QEF Regime permits a stepped-up in basis in the shares of the PFIC at the death of the U.S. shareholder.

4. Pursuant to IRC § 1297(d), in the case of a U.S. shareholder (10% of the voting stock) of a CFC that is also a PFIC, the CFC, rather than the PFIC rules will apply to such shareholder for the portion of the shareholder's holding period of the PFIC that is after 1997.

## **XII. Overview of § 367**

**A.** Tax-free treatment under the Subchapter C rules

**B.** § 367(a): Intended to prevent tax-free transfer of appreciated property by U.S. persons beyond the U.S. tax jurisdiction

**C.** § 367(b): Intended to prevent the accumulated profits of controlled foreign corporations from escaping U.S. tax

**D.** § 367(d): Special rules for outbound transfers of intangible assets; purpose similar to § 367(a)

**E.** § 367(e): Special rules for outbound distributions generally qualifying under § 355 or § 332; purpose similar to § 367(a)

## **XIII. Taxation of U.S. Persons on Dividends from Qualified Foreign Corporations**

**A.** Qualified Dividend

1. A dividend paid to an individual from a qualified foreign corporation (“QFC”) is qualified dividend income, i.e., dividend income taxed at a maximum long term capital gains rate - currently 15%. IRC § 1(h)(11).

2. Scheduled to sunset at end of 2012. Sec. 102(a), PL 111-312.

3. A QFC is a foreign corporation

a. that is incorporated in a U.S. possession;

b. that is eligible for the benefits of a comprehensive income tax treaty with the U.S., which includes an exchange of information program (*See* Notice 2003-69); or

c. whose stock is readily tradable on an established securities market in the U.S. (*See* Notice 2003-71). IRC § 1(h)(11)(C).

4. A foreign corporation is not a QFC if it is a PFIC in the year the dividend is paid or in the previous year. IRC § 1(h)(11)(C)(iii).

#### **XIV. Limitations on Deductibility**

##### **A. IRC §163(j)-Interest Stripping Rule**

1. IRC § 163(j) applies when a U.S. corporation pays interest to related foreign person.

2. If applicable, it results in disallowance of interest deduction.

3. However, the disallowed interest is carried forward indefinitely.

4. To apply

a. The payor's debt-to-equity must exceed 1.5:1, and

b. The payor's net interest expense must exceed 50% of adjusted taxable income.

##### **B. Section 267**

1. Impacts timing of deduction

2. Deduction delayed until income includible in gross income of foreign recipient

#### **XV. International Transfer Pricing § 482**

##### **A. Arm's Length Standard**

1. Commonly controlled entities must conduct their intercompany transactions based upon arm's length pricing.

2. In the case of intangible property-commensurate with income standard applies.

##### **B. Penalties**

1. IRC § 6662(e) imposes specific penalties applicable to deficiencies that are attributable to a failure to meet the arm's length standard.

2. Contemporaneous documentation may eliminate these penalties.

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