

# **U.S. International Corporate Taxation**

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FDU, Summer 2010

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# Basic Ground Rules

- **Administrative matters**
- **Course organization**
  - **Lecture, class discussions & exercises**
    - **Possible other teaching techniques ?**
  - **Short paper (memo)**
  - **Midterm & final**
- **Course-wide example facts**

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Admin matters:

1st names

Free drop; deadlines

Course org:

Format: lecture, presentations, Q&A, some Socratic method

Grading parts: per syllabus

Emphasis on outline & presentation

Cogent, concise, reasonably comprehensive

Often not many cases

**Simplify**, even at expense of precision: learning exercise, not litigation

MB & SCF here to help: organize, limit

Arrange discussion, to be held after background reading, before writing

Final & midterm: part mult choice, part short answer, 1 essay mid, 2 final

Ask questions anytime. Get our attention

What's dif between law & acctg? Don't know

Question of the day: What is confusion (mult. choice)

# Overview of U.S. International Tax Rules: The Key Rules

- Source of income
- Tax on nonresidents
- Foreign tax credit & limits thereon
  - Source of income
  - Allocation & apportionment of deductions
- Artificial shifting of income
  - Foreign corporations
  - Transfer pricing

## Residents vs. Nonresidents

- Residents taxed on worldwide income
  - Credit for foreign taxes, limited to portion of U.S. tax on foreign source taxable income
- Nonresidents taxed only on U.S. source income
  - FDAPI
  - ECI

# Foreign Tax Credit

- Granted for foreign income taxes
  - Taxpayers may choose deduction or credit for each year
- Credit limited to ratio of foreign source taxable income to total taxable income times current year tax
  - Foreign source income LESS DEDUCTIONS
- Carryover of unused credits

# Source of Income Rules

- Income from property based generally on where the property is
  - Interest & dividends: residence of payor
  - Rents & royalties: where property used
- Income from disposal of property varies
- Income from business based on where business conducted
  - Effectively connected with U.S. business
  - Exception for sales of inventory prevents artificial constructs

# Associating Deductions with Income

- Important where tax or credit based on NET taxable income
- Concept of a “class” or set of income
- Allocate deductions to income
  - Direct one to one relationship
  - May require apportionment within class to reach desired end point (e.g., FSTI)
- Apportion certain deductions
  - Interest
  - R&D
  - Other items

# Anti-Deferral

- Familiar domestic concepts:
  - Shareholders not taxed on corporate income until distributed
  - Shareholder tax limited to E&P
- Without anti-deferral rules, shareholders could shelter income from U.S. tax by shifting to an entity not taxable in U.S.
  - Subpart F
  - PFIC



## **Subpart F**

- **CFC defined**
- **10% shareholders**
- **956 deemed dividend**
- **959 actual dividends**

# Subpart F income

- **FPHCI**
- **Sales & Services**
- **Other**

## **Other Outbound Topics**

- **PFICs, DISCs & other oddities**
- **1248**
- **367**

# Income Shifting

- Section 482 prevents related taxpayers from artificially shifting income for tax benefit
  - Applies to domestic and international related party transactions

# Treaties

- International agreements may reduce tax
- Treaties may or may not modify U.S. law

# Recognition of Income

- **Normal methods of accounting**
- **Dividends recognized when paid**
- **Special anti-deferral rules**
  - **Subpart F**
  - **PFIC**
  - **FPHC**
- **Modified nonrecognition provisions**

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Q: When is corporate income recognized by S/h?

A: when paid out as dividends. What about declared but unpaid: not recog.

Basic Goals of U.S. Rules

- Fairness & equal treatment
- Deferral of corporate income for shareholders
- Anti-deferral where shareholders have use of money
- Don't disrupt normal commerce

U.S. int'l tax is primarily legislative & regulatory, little case law

Int'l tax follows basic tax rules:

Income recog. & deducts. taken under method of acctg

446 & 461 apply

Often interesting questions under 461 for int'l, e.g., timing of dedts paid to relateds.

Dividends not recog. as income until received

Special rules limit deferral of dividends & gains on stock: covered in FormII

Subpart F: applies to U.S. s/h of CFCs (explain both)

PFIC: applies to any shareholder of PFIC (explain)

FPHC: applies to s/h in closely held FC w/passive income

Overlap of rules

Some timing of recognition provisions modified:

Deductions deferred under 267, 163(j) Copyright Stephen C. Fox, 1995-2010

# Nexus to Tax

- **U.S. can in theory tax anyone**
- **Practical limits on collection**
  - Other countries won't help
  - How to reach assets
- **General principles:**
  - Tax only if some connection of person or income with US
  - Withhold tax where collection otherwise difficult

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Countries are sovereign, so they write their own rules. There is no effective world court system to resolve disputes, and the UN is mostly political  
(follow slide)

# Residents vs. Nonresidents

- **Residents:**
  - Taxed on worldwide income
  - Foreign tax credit
- **Nonresidents:**
  - Taxed on U.S. source income
  - Graduated tax on U.S. ECI
  - Withholding tax on FDAPI
- **Nonresident defined**

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Critical concept: Residency. Determines how and whether a person is taxed.  
(follow slide)



# US vs. Foreign Persons: Residency under Law & Treaty

- **Domicile for corporations**
- **183 day test for individuals**
- **Tie breakers in treaties**

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Residency a vital issue

Residency under code:

Corp: where incorp.

Indiv.: 2 tests, either or

183 day

green card

P/s: difficult questions as to p/s itself, but often irrelevant: partner taxed

Same for trusts & estates

Residency under treaties:

Fiscal domicile concept

Tie breakers

# **Taxation of Foreign Persons**

## **Graduated Tax on ECI vs. Withholding Taxes on FDAPI**

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Foreign persons not taxed same as US persons. Foreign persons taxed only on USSI  
Quick review follows

# Withholding tax on FDAPI

- **30% tax withheld by payor**
- **Rate may be reduced by treaty**
- **FDAPI includes**
  - Interest
  - Dividends
  - Royalties
- **Rental may be ECI or FDAPI**

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Nonresidents are taxed by most countries on a withholding basis. Reason: collection difficulties otherwise: they could just skip out. Almost no one extradites for tax fraud, let alone mere failure to pay.

US withholding system imposes 30% tax on FDAPI

Payor of income acts as collection agent

Treaties often reduce rates on some types of FDAPI

What is FDAPI (wing it, follow slide)

Rental income: is it or isn't it: Depends on whether trade or business. See later for whether, plus election of Tor B status

Determining whether FDAPI often determines whether to withhold, thus very important question for payor.

Q: any deductions allowed?

# Effectively Connected Income

- **Income EC with U.S. trade or business**
- **Tax based on net taxable income**
  - **Graduated rates for individuals**
- **Regular tax rules apply to determine amount**
- **Some limitations apply to deductions**

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Non-FDAPI taxed only if ECI

Q: Define ECI

Q: Define T or B

ECI taxed on net basis: can make big dif

*do rental example on board:*

Gross rent: 1000      Interest 300

Depreciation: 400      Insurance 100              Net 200

Tax as FDAPI: 300      Tax @ 39.6% of net: 79

Ordinary & necessary deductions, losses, NOL c/f, etc.

Limitations on deductions:

163(j), 267

Corp. DBI US has branch subject to BPT (later)

# Taxation of U.S. Rentals

- **30% tax on gross (FDAPI) vs.**
- **Graduated tax on net (ECI)**
- **Level of activity for trade or business**
- **Election to be ECI: code vs. treaties**

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US Tax on rental income

Question of T or B is very important, as determines whether FDAPI or ECI

What's a T or B: Very important, short shrift in text. Cover in depth later

Principal issue in T or B cases: what level of activity

Incidental transactions not T or B

Regular & continuous often used

Election of T or B status

Code: permanent for realty rental

Treaties: often have annual election

Q: can you have a rental activity with property in US & not be subject to any US tax? Yes: e.g. German treaty

# Source of Income

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# Source of Income

- **Function**
- **Importance**

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Function:

foreigners: whether taxed or not

US persons: whether eligible for FTC

Importance

# Source of Income

- **Interest, Dividends: Residence of payor. Exceptions:**
  - **Interest from U.S.: 80% active foreign business = foreign**
  - **Dividends from foreign: over 25% U.S. business = prorate**

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Broad overview of sourcing:

Int & div: residence

Exceptions:

Int from US persons w/80% foreign gross income is foreign source

Div. from FC having over 25% US gross income: pro-rate by source

Rents & royalties: where property used

Services: where performed

How to differentiate say royalties from services

Q: an example of difficult area?



# Source of Income

- **Rents & royalties: where property is used**
- **Services: where performed**

## **Source of Income: Gain from Sale of Property**

- **Resale inventory: title passage**
- **Produced inventory: 50% title passage, 50% where produced**
- **Recapture gains: where depreciation sourced**
- **Stock: various sourcing**
- **Residual rule: Residence of seller**

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overview continued

Gains from sale of prop:

false “general rule”: residence of seller

But exceptions more important

Inventory: bot/sold: title passage

produced: 50/50

Recapture (1245, etc): where deduction taken

Stock of affiliate: gain: where sold (difficult questions here)

Stock of non-affiliate: residence of seller

What is source of loss? Unresolved

# Source of Income

- **Function of sourcing rules**
- **Interest & Dividends: residence of payor**
  - exceptions
- **Services: where performed**
- **Rents: situs of property**
- **Royalties: where intangible used**

Caution: some of regs are repealed

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Function of source rules for foreigners: determining whether income gets taxed  
for US persons: determine extent to which get FTC  
Quick summary from slide

# Source of Services Income

- **Generally: place of performance of services**
- **\$3,000 de minimis rule for individuals**
  - Of limited application
- **Situs of payor, where paid irrelevant**
- **Residence of payee irrelevant**

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General rule: services are sourced to place of performance

Q: what does this really mean?

General rule applies to businesses & individuals

De minimis rule: only if total compensation is \$3000 or less (not an exclusion for first \$3000). This rule changes the source. It is not an exclusion.

• Applies only to nonresident alien individual present in U.S. for aggregate of 90 days or less in tax year.

• Services must be as employee or contractor with foreign person

Very limited application

Factors other than place of performance are generally irrelevant

Rhetorical Q: What compensation s/b attributed to particular services? (put up next slide after getting answers)

## **Source of Services Income: Determining the Amount**

- **Amount allocated should be the amount earned for the services**
- **For non-individuals: source based on facts & circumstances**
- **For individuals: actual or pro-rata amounts**
  - **Time (days) prorata based on pay status days**

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**Similar to New York formula**

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Compare to state rules: days allocation for NY, NJ

Try to allocate where particular payment for particular service

Otherwise, may need to apportion or pro-rate:

Daily pro rata method similar to New York's method approved in regs

Other methods may be more applicable

Facts & circumstances

Discuss examples from outline (2nd one is from regs)

## Source of Deferred Comp. & Benefits

- **Deferred comp sourced to place where services giving rise to option performed**
- **Qualified plan & IRA income sourced on 3 components: employee contributions, employer contributions, earnings on plan assets**
- **Benefits sourcing varies by benefit**
- **§83(b) election may change sourcing**

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Timing problems of deferred comp. of various types make applying the general rule difficult.

Stock options: 2 parts: bargain element = compensation, balance = cap gain

Q: what happens to cap gain of NRA? not taxed

Bargain element generally sourced to place services performed

What of multi-year options: How do you determine what part of comp is due to which services?

Regs sanction straight line vesting. Discuss Reg. §1.911-3(e)(4)(ii)Ex.3:

\$40K bonus for working overseas for 4 years. IRS required ratable

alloc. to each month in 4 year period for 911 exclusion

Section 83 elections can solve many problems by fixing compensation in time & associating it with a source. May also be good tax plannings: NRA performing services outside US elects §83(b), so when move to US, no tax on bargain element, even if still in earn out period

## Services vs. Other Income

- **Factual question as to what income is**
- **Incidental services follow other function**
- **Is construction services or sale of goods?**
- **Guarantee fees**
- **Noncompete agreements**
- **Royalties**

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But what are “services”? How do you tell services from something else:

installation as part of sale of goods, & other ancillary services

royalties: Piere Boulez’s revenues from record sales

noncompete agreements: an agreement not to perform (like Ken Linseman)

guarantee fees: intangible services. With these, where are they performed?

Is construction services or sales?

See outline for cases & rulings

Sale vs. royalty: Gumby

Sale vs. royalty: 2 Dairy Queen cases (the Moberg brothers, 2 dif. circuits)

# Source of Rental Income

- **Place where property is used**
- **Transportation rules**
- **Other moveable property**

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Rental income source follows property

What if property is moveable? Still follows.

How to track when property moves? See services tracking rules

Transportation assets follow special rules for transportation tax, outside scope of course.

But is it rental? What if the property is provided with substantial added services: Rental car. What if the services are really more than the rental: drilling rig (non bareboat)



# Source of Royalty Income

- **Place of use of intangible asset**
- **Sale vs. License:**
  - **Significant factual questions**
  - **Dairy Queen cases**
  - **Gumby**
- **Congress resolved issue for domestic but not international cases**

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Royalty source follows place of **use** of intangible:

ex: patent used to manufacture goods is sourced to place of manufacture  
copyright on music to place music performed

But is it a royalty: See Piere Boulez, above

Sale vs. royalty: Dairy Queen (Moberg) & Gumby (Liesure Dynamics) cases

Congressional fix: Sec. 1253 makes it capital vs. ordinary, bypassing sale vs. license issue. But this doesn't help in international area (except where the statute makes it capital)

# Source of Interest Income

- **Generally: residence of payor**
  - Individual, estate or trust: residence
  - Corporation: place of incorporation
  - Partnership: place where partnership does business
- **U.S. interest excludes interest on deposits paid by foreign banking branch**
- **Residency determined at time of payment**

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General rule. Modification for branch interest: US source if deductible in US  
Interest paid by US govt or agency or instrumentality is US source

Q: What is source of interest paid by states?

Time of determination

Exceptions to US source: from foreign branch of US bank

from US corp. meeting 80% test

## **Source of Interest Income: Definition of Interest**

- **Same as rest of code**
- **See §§483 & 163**
- **Includes OID on notes in excess of 183 days**
- **Includes imputed interest under §7872**
- **Excludes market discount under §1276**

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Regs make reference to Sec. 483 in defining interest, but the 483 regs are not particularly instructive. Sec. 163, however, has more extensive definitions

Interest generally includes any payment for “use or forbearance” of money

This includes discounts, commitment fees, stated interest, and unstated interest under Sec. 483

Short term OID carved out: normal terms of commercial paper. Elaborate on what this means

## **Source of Interest Income: 80% Foreign Business**

- **U.S. source interest excludes interest paid by a resident alien or domestic corp. meeting 80% foreign business test:**
  - 80% of gross income is from
  - Active foreign business for
  - 3 years ending with preceding tax year
- **For 80% test, look thru related person interest**
- **All or nothing basis: not prorated**

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861(a)(1)(A). Interest defined 861(c)

80% foreign business carve out: 3 part test:

80% of gross income

Active conduct of T or B in foreign country

Preceding 3 years

Gross income: define. Excludes items excluded by code

What is an active business? This is TRA 86 provision; no regs yet. Does it include wages? unclear

Follow slide

## **Source of Interest Income: Partnership Debtors**

- **US source if partnership engages in US trade or business during year**
- **Classification issues become important**

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Interest paid by p/s: US if P/s engages in any TorB in US during the year of payment

Q: What's a P/s? Sec. 7701

Q: Should a p/s winding down with foreign partners it owes money delay payment until after TorB shut down?

## **Source of Interest Income: Special Issues**

- **Guarantor: residence of guarantor ignored, even if guarantor pays**
- **Individual residency determined under §7701(b) or treaty**
- **Residence of trust or estate is facts & circumstances**
- **US, state, & local government interest is US source**

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Guarantee fees: are they interest

What of payment by guarantor? see \_\_\_\_\_: guarantor basically ignored, look @ residence of original obligor (if guarantor functioning solely as such)

Residency determinations: see later. Law or treaty

# Source of Factoring Income

- **Related person factoring income treated as interest on loan to obligor**
- **Results in U.S. source income from U.S. receivables**
- **Limited to:**
  - **FPHCs**
  - **Subpart F**
  - **FTC**

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Q: describe factoring

Follow slide

Stress limitation of provision: will not cause w/h tax

Basically an outbound only issue

## Source of Dividend Income

- **General rule: place of incorporation of payor**
- **Possessions corp. dividends are FSI**
- **U.S. source may include dividends from foreign corporation**
  - **If more than 25% of its gross income was U.S. ECI for**
  - **Preceding 3 years, then**
  - **Pro-rate dividend according to gross income**

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Dividend source: place of incorporation of payor

However, 936 corp. pays foreign dividends.

However, foreign corp. dividends can be USSI: see slide

Watch out: regs are old & wrong

How about a FSC? It's a foreign corp, but nonexempt portion is USSI



## Source of Income: Sale of Property

- **Resale inventory: title passage rule**
- **Produced inventory: 50/50 rule**
- **Depreciable property: follows deductions**
- **Residual (general?) rule: residence of seller**
- **Other**
- **What is a sale? Includes “exchange or other disposition”**

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Sale of prop: general rules: follow slide

Sec 865's backwards general rule

Other: contingent payments:

- goodwill: where generated
- other: considered a royalty & sourced to where used

Stock of affiliate: special rule

What is a sale? Discuss implications of “other disposition” rule

Partnerships: applied at partner level. Impact of “residence” rule: can have same item sourced differently for different partners

## **Source: Fixed Place of Business**

- **Residents: certain income is FSI if attributable to fixed place of business outside US**
- **Nonresidents: all income is USSI if attributable to fixed place of business in US**
  - **Exception: Does not apply to inventory for use outside US if foreign office materially participated**

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Sale thru fixed place of business (these are treaty terms):

- residents: if not sourced under inventory, recapture, contingent payment, goodwill, or affil. stock: if attrib. to fixed place outside US, then FSI, but only if taxed locally at 10% or more

- nonresidents: sourced US regardless of other provisions if attributable to office or other fixed place of business in US. However, does not apply to sale of inventory for use, etc. outside US if foreign office materially participated

# **Sale of Purchased Inventory**

- **Title passage rule**
- **Where does title pass**
  - **Shipping terms**
    - **FOB**
    - **CIF**
    - **C&F**
    - **Ex Works**
  - **Explicit title passage**

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Discuss title passage concerns

Discuss what title passage means:

- economic risks transferred
- paper title transfer

INCO terms: what they are, etc

FOB is inappropriate for most int'l shipments

# Sale of Purchased Inventory

- **When does title pass**
  - Bare title passage
  - Economic risk
  - Actual actions of parties contrary to contract
- **Manipulation of sourcing rules**

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**Instructor note:** Read the article in International Tax Journal (about 1992)re: title passage & 863(b)

# Mixed Source Rules: Overview

- **US produced, foreign sold, or vice versa**
- **50/50 Rule**
  - 50% to place produced
  - 50% to where title passes
- **Independent factory price**
  - Elective
  - Special rules for post-production activity
- **Natural resource rules**

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When 863(b) applies

New rules have election to use IFP or 50/50 rule. Once elected, can change only w/consent (not to be unreasonably withheld)

Methods similar to old rules, but not identical. Will discuss in detail

New rules on natural resources (after 70 years of waiting)

Brief review of title passage rules, incl. FOB vs. ex works vs. FCA

## 50/50 Rule

- **Strict bifurcation:**
  - 50% to production activity
  - 50% to sales activity: title passage rule
- **Apportion production piece based on assets:**
  - Include only production assets
  - Exclude inventory, receivables, warehouse, etc

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### Bifurcation of activity

Sales: strictly where title passes

Production: if all 1 place, then all sourced there

if mixed production, then apportion based on production assets. Exclude

inventory            distribution assets            A/R

cash                    warehouse (even for materials)

Only production activities taken into account are those performed directly by TP & consol. return affiliates.

Old rules apportioned net income

New rules apportion gross income:

for 50/50 rule, appears to be same due to “pro rata” rule

for IFP may have substantial impact on interest apportionment: no longer

mixed source assets

## **50/50 Rule**

- **Apportions gross income, then deductions separately allocated**
- **Application is simple where no mixed situs production**

## **Independent Factory Price**

- **IFP is a production-only price: designed to exclude marketing activity**
- **For an IFP to exist, the taxpayer must**
  - **Regularly sell part of output**
  - **To independent distributors in such way as to**
  - **Fairly establish an IFP**

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compare to old rule: needed foreign branch



# Independent Factory Price, cont.

- **Applies only to**
  - **Substantially similar inventory sold under**
  - **Substantially similar conditions in**
  - **Substantially similar geographic markets<sup>4</sup>**

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IRS fights many comparability cases under 482 on these grounds. Often difficult to argue that US & foreign are similar, thus IFP sales must be to foreign customers. Shipping terms (e.g., FCA) could defeat this. IRS has often fought IFP & won. New rules are, if anything, more difficult than old ones.

IFP requires “substantially similar products”. Thus, must separately “fairly establish” IFP for different models of same machine or different grades of bulk goods.

# Sale of Other Property

- **Recapture items**
- **Gain on stock of affiliate**
- **Loss on stock of affiliate**
- **Contingent payment for intangibles = royalty**
- **Non-contingent goodwill**
- **Other intangibles**

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Other rules:

Recapture items: where depreciation sourced under deduction rules

(generally where property used at time of depreciation ded)

Gain on stock of affil. w/50%+ gross income from active business in its country of incorp: FSI

Loss: domestic if domestic seller

Contingent payments for sale of intangibles: treated as royalties

Goodwill: where generated

Other intangibles: “general” rule

Gain on certain stock & intangibles under treaty: Sec. 865(h): elective to treat as FSI, but certain FTC provisions applied separately

# Source of Income: Items on Checklist

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Work through the checklist, asking each item in turn of a student

# Taxation of Nonresidents

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## **Withholding Taxes: General Rules**

- **30% tax on gross income**
- **Rate reduced by treaties**
- **NO DEDUCTIONS**
- **Payor responsible for withholding, faces penalties for failure**
- **No return: Final tax (except compensation)**

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**Instructor note:** Read the Harvey Dale article in Fall 1980 Tax Law Review

## **Withholding Tax: Income Subject to W/h**

- **US source FDAPI: interest, dividends, rents, royalties**
- **Other FDAPI**
- **Generally, any U.S. source income not effectively connected with trade or business**
- **What are wages?**

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Applies only to US source income  
(review of prior material)

Wages: ECI per regs, despite ambiguity in code. Taxed at graduated rates per regs, & subject to regular wage withholding.

## **When Withholding Applies 6 Step Test**

- **Recipient is “foreign” person**
- **Amount is U.S. source income**
- **FDAPI**
- **Not ECI**
- **Withholding agent involved**
- **No applicable exceptions**

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No withholding unless all six tests met

Follow slide. Residency rules covered later

Need both FDAPI and Not ECI tests, since some FDAPI may be drawn into ECI

Q: what sort? examples: interest on operating bank acct or trade notes receivable

Certain exceptions apply, discussed in part later. Most are of very limited application

Q: Example: 1. GM pays interest to Sir Geoffrey. W/h req'd? Yes

2. GM pays foreign corp. for performance of services in US

W/h req'd? No: ECI

# Who's Subject to Withholding

- **Nonresident alien individuals**
  - Reliance on statements of residence
- **Foreign corporations**
  - Charities?
- **Foreign fiduciaries**
- **Foreign partnerships**
  - What of partners?

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Not all persons subject to w/h. Those listed above are

Statements: Forms 1001, W-8

Charities: Foreign charities likely don't qualify under 501(c)(3), and often aren't protected by treaties. Thus foreign charities having FDAPI may pay tax.

Example: Dutch religious order (under old treaty) had to pay tax  
on earnings of its pension plan

Partnerships: For this purpose, any p/s organized outside US and not doing business in US. Partnership w/h provisions under 1441, 1446



# Withholding Procedures

- **Complex §1441 regulations**
- **Withholding Agents**
  - U.S. or Foreign
- **When to withhold**
- **Who is subject to withholding**
- **Forms, filing deadlines, payment**
- **Cash basis**
- **Qualified Intermediary rules**

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New Form W-8 & certification procedures

Annual statement for ECI exception: Form 4224

When must forms be in hand by w/h agent:

- Official rule: before payment made
- Field agent rule: before the agent needs it
  - = But no good if payee does not pay tax due
- Court case: Casanova: before the case hits tax court is OK

# Effectively Connected Income

- **Defined**
  - Income
  - Effectively connected with
  - U.S. trade or business
- **How taxed**

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Brief intro only

## ECI vs. FDAPI

- **What level of connection required?**
- **Services give rise to trade or business**
- **Royalties**
- **Trading in stocks**
- **Trading in commodities: special rule**

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Services are ECI under 864(b) unless \$3000 exemption applies

Stocks: no T or B by virtue of trading thru US broker, etc., if TP has no office in US

Securities: no T or B if trading for own acct unless principal office in US

Commodities of a kind regularly traded on exchange: no T or B by virtue of trading thru US broker, etc., unless office in US. No T or B if trading for own acct, but exception does not apply to dealer.

These exceptions are very specific. See regs & code

# Doing Business

## What is doing business?

- **Selling**
  - **Exceptions**
- **Performing services** incidental sales
- **Rentals**
- **Other business activities**
- **See cases under §162**

# What is a Trade or Business?

- **Level of activity important**
  - occasional transactions not T or B
  - Regular, continuous & substantial
- **Must have revenue generating activity**
  - Mere promotion is not T or B
  - Research is not T or B
- **Can be direct or indirect**
  - Such as thru partnership or agent

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Source of cases: Sec. 162

Profit motive usually not germane

Q: what types of factors lead to T or B in domestic law? Discuss thoroughly

Q: what are effects of activities of agent

Discuss: triple net lease

investor vs. trader

What is an occasional transaction:

-two sales of thread are (next slide)

-one sale of steel foundry is not

## What is a Trade or Business in US? Cases

- **Linen Thread Co: a few sales: no T or B**
- **European Naval Stores: no place of business**
- **Scottish American Investment Co: clerical office is not place of business**

1. 14 TC 725 (1950)

2. 11 TC 127 (1948)

3. 12 TC 49 (1949)

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Linen Thread: US agent acquired authority to sell for Linen Thread. However, only 2 sales made in year in question due to export limitations. Thus, lacked regularity & continuity. Also, sales were small \$

Euro Naval: Sales into US to affiliate: Euro had no office of place of business, & no agent in US

Scottish: maintained office in US with staff, etc. However, sole function of office was to do clerical tasks related to portfolio of investments. No sales or revenue activity

One of the keys is revenue generating (or potentially revenue generating) activity, such as sales or services. Generally research, advertising, admin, etc. don't give rise to T or B

## Determining U.S. T or B Income

- Includes income from the business activities
- Deductions allocated under rules discussed below, EXCEPT
  - Special interest apportionment rules for foreign corporate branches in U.S.
- Regs say deductions denied if no return filed, but overturned in *Swallows* case

# Tax Treaties

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# Treaties

- **General provisions**
  - Residency
  - Taxes covered
  - Permanent establishment defined
  - Taxpayers covered
- **Nearly 50 US treaties in force**

# Treaties

- **Every treaty is different**
- **Typically reduce withholding rates on:**
  - Dividends (often 5-15%)
  - Interest (often 0 )
  - Royalties (often 0 )
- **Limits on taxation of ECI**
- **Competent authority**

# Treaties: Residency

- **Fiscal domicile vs. actual domicile**
- **Corporations or businesses**
- **Individuals**
- **Tie breaker clauses**

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Common provisions:

Body corporate vs. company:

usually covers one or other

Fiscal domicile often place of management for co.

- can result in anomalies

To be resident under treaty, must be resident under local law for nearly all treaties.  
Thus NRA not US resident under treaty even if he meets tie breaker

# Treaties: Permanent Establishments

- **PE is nexus level to tax**
- **PE is:**
  - **Fixed**
  - **Place of**
  - **Business**
- **Common inclusions & exclusions**

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Must have Fixed, Place & Business. All else is example or exclusion  
OECD commentary provides good guidance

# Fixed

- **Not moveable**
- **Some degree of permanence**
  - **Not just a few weeks or months**
- **Market stall can be fixed if assigned**
- **Equipment constituting business need not be “fixture”**

# Place

- **Some identifiable situs**
- **Physical location defined**
  - i.e., not “somewhere in the building”

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Need not be leased or permanent facilities. Can be on loan, especially if from related person

## Of Business

- **Business must be conducted**
  - Does not need to be even a material portion, just some
- **This generally means revenue generating activity**
  - Sales office
- **Research or administrative office is not a place of business**

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Discuss & get class to give examples of fixed place of business

## **Agent's Activities**

- **Activities of an agent may be attributed to a principal**
- **Generally requires that agent “regularly and habitually” exercise powers as agent**
  - Thus occasional sales don't count
- **Agent's place and conduct of business may be attributed**
  - Can create PE
- **Often exclusion for agents who are independent and acting in ordinary course of their business**

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Note that PE provisions usually follow OECD and Treasury models



# Agency Generally

- **General definition**
- **Requires three parties**
  - **Principal**
  - **Agent**
  - **Third party relying on agency**
- **Agency relationship may cause U.S. taxation**

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Erase the board. Put this on board:

Agent: one who acts

Principal: one on whose behalf action is taken

This section is designed to be a brief overview of agency for accountants. Ideally should be presented by an attorney in the class as one of student presentations. Note that the class is likely to have very little grasp of the subject before this presentation. Take it slow.

Agency: that relationship in which one person (entity, etc) (agent) is empowered under the relationship to act on behalf of the other (principal). Generally, it is necessary that the agent have the power to bind the principal to contracts.

The concept of agency is irrelevant until a third party relies thereon.

Under US tax concepts, the activities of the agent may be attributed to the principal in some cases, which may cause the principal to be considered doing business in the US.

## **Agency: Authority to Bind**

- **No agency without authority to bind principal in contracts**
- **Practical vs. stated authority:**
  - **Ratification can defeat denial of authority**

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Agency does not exist without the authority of the agent to act on behalf of the principal and in the principal's name, generally conferring a power to bind the principal to contracts without further authorization.

This differentiates a representative from an agent. A Rep has power to solicit, etc., but not power to bind.

Discuss w/class what this authority means.

Get examples & differentiate solicitation from agency.

On board write: Agency: power to bind

“When someone tells you of agency or lack thereof, don't believe them unless the person is an attorney or took this course.”

# Agency Relationships

- **Express agency: by agreement**
- **Implied agency: by agreement or action of parties**
- **Ratification**
  - **By action of principal**
  - **Express or implied**

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Discuss the various aspects of agency, including express & implied, oral & written  
Requirements for agency to exist:

1. Capacity to do the contemplated act or hire it done
2. Identifiability of acts
3. Purported agency
4. Competence to act
5. Knowledge by agent & principal of facts
6. Not cancelable by third party
7. Rights of 3rd party must not be cut off by ratification

Discuss what acts the principal may/must take to ratify the acts of the agent, and what limited actions are available to repudiate.

Apparent authority:

- holding out by principal:
  - active: gives rise to agency
  - by inaction: implies agency
- 3rd parties may reasonably rely

Estoppel: principal estopped from disclaiming where past actions ratify

Undisclosed agency. Common vs. civil law re: undisclosed agent

Terminating agency:

- By acts of parties: notice of revocation to those relying
- Lapse of time or purpose achieved: automatic termination
- By operation of law: death, insanity, illegality, bankruptcy, war

## **Agency: Attribution of Activities**

- **Activities of agent may be attributed to principal**
- **This may cause US tax:**
  - **Permanent establishment**
  - **Doing business**

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Key impact for US tax: as above.

Acts of agent are as if performed by principal itself

Really hammer this in.

On board: Acts of agent attributed to principal

Example:

US agent distributes goods in US:

- as agent vs.
- as distributor (sales representative)

Q: what law covers agency? State/local law

## Partnership as Agency

- **Basic concept of partners is agents for one another**
- **Partners have ability to bind other partners** in the conduct of p/s business
- **Partners considered doing business in US thru PE if partnership does**

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The whole concept of a p/s is the ability of a partner to bind the other partners. This is agency. This ability may be limited by statute or contract (p/s agreement). This binding action is only through p/s itself. 3rd parties may rely on this implied agency unless they actually know otherwise.

This broad agency relationship results in the partners being attributed the activities of the p/s. See whole Subchapter K. Thus, if p/s does business in US, each partner is considered doing go.

Impact: partners taxed on p/s ECI.

Additional impact: force of attraction impacts partners, even if p/s is their only US activity

# Selling “Agents”

- **Agent vs. sales rep**
- **Limited agency**
- **Avoiding agency**

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Differentiate sales reps from agency. Ask for examples from experience

Limited agency: might be a way to avoid ECI. What it takes

Agents: captive representative with authority

Sales Reps: example: real estate “agent” has no authority to bind

# Independent Agents

- **Activities of independent agent acting in ordinary course of business often not attributed to principal**
- **Ordinary course of business**
  - **Of the agent**

Need multiple principals

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Independent agent defined

Limits on attribution of indep. agent's activities: very strong under treaties, but less so under domestic law.

Discuss examples of reps & agents presented earlier

# Independent Agents

- **Independence**
  - **Entrepreneurial risk of agent**
  - **Detailed control**
  - **Dependent agent need not have equity relationship**



## Dependent Agents

- **Activities generally attributed to principal, but only if**
- **Activity is regular and continuous, and**
- **Activity is in name and for account of principal**

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Define dependent agent. Usually captive. 1 principal, agent under principal's control.

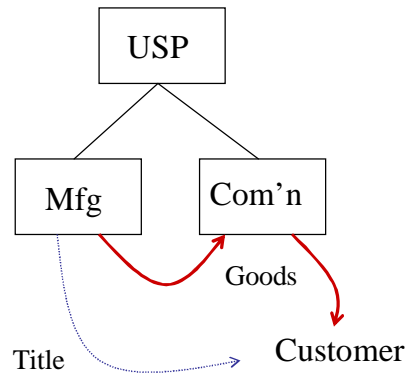
When activities attributed: slide

Discuss subsidiaries as dependent agents

When can a sub be independent, given entrepreneurial risk req?

# Commissionaire

- **Not an agent under civil law**
- **Acts like agent**
- **Provides insulation against tax of U.S. parent**



# **Income Properly Attributable**

- **Intercompany pricing concepts apply**
  - Consider functions and risks
- **Likelihood of tax authorities challenging**

# Treaties

- **Dispute resolution: Competent Authority**
- **Anti-double tax clauses**

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Comp. authority is usually available, but expensive & takes forever: typically 2+ years

# Treaties

- **Common special provisions**
  - **Artistes & athletes**
  - **Scholars & trainees**
- **Oddities**
  - **UK ACT credit**

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Discuss what ACT is & what it does

Refund 1/2 ACT

Walk thru simple example

# Treaties: New Concepts

- **Limitation on benefits clauses**
  - Netherlands, Mexico, UK, Canada protocol
  - Prevents treaty shopping
  - New level of complexity
- **Tax sparing**

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LoB clauses: similar to 884 regs

Catching on in rest of world

Usually contain:

look thru to s/h

active business test

# Treaty Shopping

- **Not prohibited, but IRS hates**
- **Anti Treaty Shopping provisions in:**
  - **Branch profits tax**
  - **New treaties**
- **7701(I) regulations:**
  - **Sham: Aiken and Rev. Ruls. 84-152 and 84-153**
  - **Recharacterization under regulations**

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Treaty shopping still possible

Example: Royalty paid from Algeria to France to US: no withholding up chain, no problem w/7701

## Treaties: Info. Sources

- **CCH treaties service: hard copy & CD**
- **IBFD: same (based in Amsterdam)**
  - International Bureau of Fiscal Documentation
- **In-Depth Publishing: Tax Treaties Service**
  - Includes OECD model & commentary
  - Includes most rulings & cases for all OECD countries
- **Rhodes & Langer: appendices**
- **BNA portfolios**
- **Country (e.g., IRS) Web sites**



## **Treaty Based Return Positions (TBRP): §6114**

- **What is a TBRP?**
  - Any position that reduces US tax if
  - The position is due to a treaty
- **Can have TBRP without any return required**

## Reporting TBRPs

- **Any taxpayer with TBRP must report**
- **If no return otherwise required, must file return just to report**
  - Return may be 1040NR or 1120F with no info. but name, address, id# & 6114 schedule
- **Limited exceptions for items from affiliates reported on Form 1042S**

# How to Report TBRP

- **Schedule attached to return showing:**
  - “TBRP under §6114”
  - Name & ID # (if any)
  - Amount & type of income
  - Treaty country
  - Treaty article
  - Reason for reduction

## **Penalty for Failure to Report TBRP**

- **\$10,000 for corporation**
- **\$1,000 for individual**
- **Applies to each failure**
- **Potential loss of all deductions**

# Foreign Tax Credit

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