Chapter One: Introduction

Problem of Primary versus Secondary Taxing Jurisdiction:

1) Inbound investment and business activities (US Taxing Jurisdiction: Primary; Home Country: Secondary Taxing Jurisdiction)

2) Outbound investment and business activities (US Taxing Jurisdiction: Secondary; Host Country: Primary)
The Process of Going Outbound: When Are We “In” The Host Country Sandbox?

1) US MNC Exports tangible goods to the Host Country
   a. Sell goods to customer at US Port.
   b. Commission Agent in Host Country that manages customer relations

2) Licensing of intangibles (patents, software, know-how, etc.)

3) Investment in non-movable assets in the destination jurisdiction

What are the US tax consequences?
The Process of Coming Inbound: What level of activity triggers US primary taxing jurisdiction?

1. Passive investment in the U.S. Securities (stocks & bonds); Real estate

2. Send company employees to the US.
   a. Tax consequences to employee?
   b. Tax consequences to the company?

3. The company establishes a fixed place of business in the U.S.
Capital export neutrality – same tax rate regardless of the location of taxpayer’s income (but a possible higher foreign tax cost if foreign higher than U.S. tax rate)

Capital import neutrality – all firms in the same market are subject to the same rate of tax. Only country where the investment is located imposes tax.
1) Territorial/exemption system as current tax proposals

2) Foreign Tax Credit System – the source country has the priority to tax. Or, a deduction for the foreign tax paid.

3) An agreed allocation of the income tax liability – e.g., lower withholding rates at source – a bilateral response.
1) Taxation of branch income - §61

2) Foreign Subsidiary – respecting the foreign legal entity status. But, possible U.S. income tax applicability of “Subpart F” (Subchapter N) limiting U.S. deferral.

Consider transfer pricing opportunities (p. 27)
Achieved through (1) income characterization rules; (2) use of “hybrid entities” (e.g., corporation in one jurisdiction but flow-through entity in other jurisdiction); and (3) income shifting to tax haven locations.
What does this picture tell us about Tax Policy?
Trade or business income – p. 36
§§871(b) & 882 – net income tax.

What is a “trade or business” in U.S.

What income is “effectively connected” with a U.S. trade or business?

Also – a “branch profits” tax is applicable – in lieu of a withholding tax on a dividend distribution. Cf., treatment of subsidiary.
Investment income taxed - §§871(a) & 881 (a).

**Gross** withholding “at source” is applicable.

Exemption from income tax liability for:
portfolio interest, bank interest; capital gains on stock & securities

No. U.S. income tax exemption for (1) real estate income (including sales) (§897); or, (2) contingent royalties (§871(a)(1)(D) & §881(a)(4)).
Inbound: Summary

Question: How Are Inbound Activities Taxed?

Answer: Active Business: Net Basis Taxation
Passive Income: Withholding
1) Taxation on worldwide income

2) Relief from double taxation –
   - direct credit
   - indirect (or “deemed paid”) credit

3) Possible deferral of U.S. income tax (p. 34)
   - subject to: - Subpart F regime; PFIC rules

4) Possible exemption from tax - §911 (p. 34)
Individuals – Citizens of the U.S.

**Cook v. Tait** p. 35 – issue concerns the U.S. power to tax a foreign resident U.S. citizen on foreign sourced income:

(1) A U.S. constitution claim? (2) An international law claim?

U.S. income tax jurisdiction is based on U.S. citizenship status.
§7701(b) definitional provisions:

(1) “Green Card” test or

(2) “Substantial Presence” test
    how computed?

(3) “Closer Connection” exception (p. 39) - §7701(b)(3)(B); less than 183 days in U.S. & tax home in the other country. §162(a)(2) re “tax home”.
Commuters

Travelers in transit

Diplomats & international organization employees

Certain professional athletes

Medical condition arising while in U.S.
Availability of deductions (e.g., expropriation losses in former country).

Cf., deductions for nonresident aliens – only for those expenses attributable to the related U.S. business activities.
i) §7701(b)(3)(A)(i) – physically present in the U.S. for at least 31 days in year 3.

ii) §7701(b)(3)(A)(ii) – 193 days of deemed physical presence

Year 3 (current year) 120 days
Year 2 (first preceding year) 50 days (1/3\textsuperscript{rd} of 150 days)
Year 1 (second preceding year) 23 days (1/6\textsuperscript{th} of 138 days) 193 days

continued
iii) Question re qualification for closer connection exception – §7701(b)(3)(B).

§7701(b)(3)(B)(i) – physically present in U.S. for less than 183 days in year three.


§7701(b)(3)(B)(ii) – the “closer connection” test.
“Landed basis,” i.e., not a “mark-to-market” tax basis regime when U.S. status is commenced.

Therefore: i) Sell gain assets (how accomplished?), and ii) Retain loss assets (for sale when subject to U.S. worldwide taxation).

How prove U.S. income tax basis for the prior foreign acquired assets?
Expatriations occurring after 6-17-2008.

Applies a mark-to-market taxation regime on U.S. source income.

A “covered expatriate” deemed to sell all worldwide property for FMV on the day before his expatriation.

Taxed on gains above $636,000 (indexed for inflation for 2011)
“Covered expatriate” – Individual with average annual income amount ($147,000 for 2011) or net worth ($2 million) at date of the individual’s expatriation.

Exceptions for certain dual citizens at birth (if not meeting substantial presence test).

A covered expatriate can include certain long-term alien residents.
Covered expatriate can elect to defer payment of the tax under an actual sale or exchange, failure of security or death.

Must provide “adequate security.”

Must wave U.S. tax treaty benefits.

Interest accrues on the unpaid tax at 6%.

If death before all deferred tax is paid, then this tax is due on the final income tax return.
Exceptions to the mark-to-market rules:

1) Deferred compensation items.

2) Interests in nongrantor trusts

Code §2801 – a new succession tax – Gifts & bequests to U.S. persons from a covered expatriate are taxed to the recipient at the then highest gift or estate tax rate.
Definition: Code §7701(a)(1), (3), and (4).

“Corporation” includes associations, joint-stock companies and insurance companies.

What is a ‘corporation” (for U.S. tax)?

“Choice of entity” or “check the box” rules.
U.S. Partnerships (& LLCs)

Flow through income tax treatment for both the U.S. and the foreign partners.

Foreign partnership & foreign income – no deferral for U.S. partners since need foreign corporate status to avoid conduit, transparent treatment; includes an LLC treated as a partnership.

Planning: Use a foreign “blocker” corp.
How determine entity characterization?

“Check the box” rules, but listing of certain foreign entities as “per-se” corporations (as categorized for U.S. tax purposes).

Other entities are ‘eligible entities” – which can elect – ordinarily for conduit status.

Consider impact of “default” rule on status.
§7701(a)(30)(E) – redifferentiating between a U.S. trust and a foreign trust:
- U.S. court test
- U.S. fiduciaries & control test

§7701(a)(31)(A) – estate status
Definition of a foreign estate as an estate not subject to taxation on its worldwide income. Otherwise, a U.S. estate.

Where are the assets? Where is the primary estate administration occurring?
Problem – U.S. Cleanliness and Camclean Foreign Sub.  
p. 61

Issues:

A)  Right of the U.S. to tax under international law?

B)  What basis for the exercise of tax jurisdiction by the IRS?

C)  Taxability in the United States?

D)  If taxability, then how:  on (i) a gross withholding basis or (ii) a net income basis?

Camclean earns:
- **US Interest** (portfolio interest?)
- **US Royalties**
- **US Capital Gains**
- **Gains from sale of US IP**
- **Service Income in Compania**
- **US Dividends**
- **Service Income in US**
§894(a)(1) – “due regard” for treaties.

Purposes of bilateral income tax treaties:

1) Define “residence” status.

2) Tax rate reductions – avoiding double taxation (allocate income to residence?)

3) Cooperation between taxing authorities and enable the exchange of tax information.
Other Relevant Tax International Agreements

1) Tax Information Exchange Agreements

2) FCN Treaties – Friendship, Commerce and Navigation Treaties

3) Memoranda of Understanding (MOUs) on specific issues: Note IRS Announcements 2006-4, 2006-5 & 2006-6 (Japan, Canada and Mexico).

4) Mutual Legal Assistance Treaty – criminal matters, including tax.

5) Social Security Totalization Agreements
Model Income Tax Treaties

1) U.S. Model (2006, as modified by subsequent bilateral U.S. treaties?)

2) OECD Model – dynamic, i.e., under regular revision process (see U.S. Tech. Explanation notation.)

3) U.N. Model – developing countries perspective is included
1) Negotiation by U.S. Treasury Department representatives (& IRS).

2) “Advice & consent” by U.S. Senate, after review by Foreign Relations Committee (not the Senate Finance Committee)

3) No U.S. House of Representatives participation in the tax treaty process.

4) Effective upon an exchange of instruments of ratification. Cf., Vienna Convention on Treaties.
Business Income – tax if a “P.E.”; Cf., sales income but no P.E. in foreign jurisdiction.

Personal Services Income – 183 day rule & income not from U.S. fixed base.

Nonbusiness Income – reduction of the rate of tax withholding at source.

Capital Gains – tax immunity at source, except real estate.

Other Income – tax at residence.
Taxes covered – p. 59 – “income taxes” (and in other country?)

-not state taxes. Cf., California “unitary taxation”

Resident status defined (p. 60) – “tie-breaker” rules are applicable.

“Savings Clause” for U.S. taxpayers.

Tax expatriation provision is included.
1) Third Foreign Country Corp owns 100% of

2) Netherlands Corporation ("participation exemption") owns 100% of


(next slide)
Limit “treaty shopping”? How?

1) “Form vs. substance” – Aiken Industries case.

2) Statutory anti-treaty shopping rules – e.g., Code §884(e).

3) Anti-conduit rules – Code §7701(1).

4) “Limitation of benefits” – provisions in income tax treaties.
Treaty Nondiscrimination Provision pp. 69-70

Model Treaty, Article 24

1) Provides for taxation of nationals of the other country – no more burdensome than taxation of locals – assuming the same circumstances.

2) Applicability of tax treaty provisions to states in the U.S. (but not other tax treaty provisions).
Possible income taxation of Wolfgang in the U.S.?

Is relief available under an applicable income tax treaty?

Note: “tie-breaker” rules in tax treaty Article 4(2) may apply concerning determination of residence status.
Nonresident with income sourced in the U.S.:

- Interest income from U.S. loan

- Compensation income from consulting job – No office or fixed place of business in the U.S.

1) Information provided to the other country:
   a) Routine exchanges
   b) Spontaneous exchanges
   c) Specific requests

2) Mutual agreement procedures

3) Privacy concerns – see §6103(k)(4) re IRS sharing information with treaty partner
Code §7852(d)(1) – provides that neither tax treaty nor a Code provision has preferential status.

“Later in time” rule of priority – Code or the applicable treaty.

“Treaty Override” issue – can/should Congress override a tax treaty? If so, delayed effect?