Presentation:

International Income Taxation
Chapter 1: INTRODUCTION
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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)
The Nagging Problem: Potential “Homeless Income” or BEPS (p.33)

Foreign-Owned

- Foreign-Owned Parent
  - Supply Chain
  - Lease Stripping
  - Interest Stripping
  - Royalty Stripping
  - Service Stripping

  Swiss Subsidiary
  US Domestic Subsidiary

US-Owned

- US-Owned Parent
  - Supply Chain
  - Lease Stripping
  - Interest Stripping
  - Royalty Stripping
  - Service Stripping

  US Domestic Subsidiary
  Swiss Holding Company
  Third County Operations

February 12, 2013 OECD BEPS Report:

- “Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.”

- “Further, as businesses increasingly integrate across borders and tax rules often remain uncoordinated, there are a number of structures, technically legal, which take advantage of asymmetries in domestic and international tax rules.”

- “Business leaders often argue that they have a responsibility towards their shareholders to legally reduce the taxes their companies pay. Some of them might consider most of the accusations unjustified, in some cases deeming governments responsible for incoherent tax policies and for designing tax systems that provide incentives for Base Erosion and Profit Shifting (BEPS).”
What does this picture tell us about Tax Policy?
Some Diagramming Conventions

- **US Corporation** ➔ Entity Treated as a US Corporation for US and Non-US Tax Purposes

- **Non-US Corporation** ➔ Entity Treated as a Non-US Corporation for US and Non-US Tax Purposes (I often use “Green” for a Treaty Based Foreign Corporation)

- **P/S (US)** ➔ Entity Treated as a Partnership for US and Non-US Tax Purposes

- **US Branch** ➔ Entity Treated as a Branch for US and Non-US Tax Purposes

- **P/S (Non-US)** ➔ Entity Treated as a Partnership for US and Non-US Tax Purposes

- **Non-US Branch** ➔ Entity Treated as a Branch for US and Non-US Tax Purposes

**Hybrid Type Entities That Have Inconsistent Characterization**

- **Foreign Company** ➔ Hybrid Entity: Entity Treated as a Non-Entity for US Tax purposes (it is “open”) but as a “corporation” for non-US Tax Purposes.

- **Foreign Company** ➔ Reverse Hybrid Entity: Entity Treated as a Corporation for US Tax purposes (it is “closed”) but as a “partnership” or flow-through vehicle for non-US Tax Purposes.
Inbound Taxation: Net Basis Tax of Active Business Income

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).
1) Taxation on worldwide income

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

3) Possible exemption from tax - §911 (p. 34)
U.S. Corporations– Taxed on US Territorial Income But Subject Anti-Deferral Rules

1) Taxation on US ECI

2) Dividend relief–
   - 100% foreign DRD
   - Foreign Income not eligible for DRD regime entitled to 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.
Foreign Persons: Individual Performs Personal Services
Resident Alien Status

§7701(b) definitional provisions:

(1) “Green Card” test or

(2) “Substantial Presence” test-- how computed?

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

How Are Inbound Activities Taxed?

- US Trade or Business for Employee
  (§864(b) see Ch.3)

- No Tax Return
  < 90 days & < $3,000
  US Trade or Business for Employee
  (§864(b) see Ch.3)

- Tax Return
  (US Connected Income only) Resident Alien or US citizen?

- Tax Return
  (All worldwide income)
§7701(b) Exceptions

- 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. See Rev. Rul. 80-17 (discussed on page 47).
Problem #2: Wolfgang
Substantial Presence Test?

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 three 120 days
   Year two (1/3 test) 50 days
   Year one (1/6\textsuperscript{th} of 138 days) \textbf{23 days}

   193 days

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

   1) Physically present in U.S. < 183 days in year 3.
   2) “Tax home” in another country exists, and
   3) The “closer connection” test is met.
“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?
“The first quarter of 2015 set a record for expatriations by U.S. taxpayers. The data released today follows two consecutive years where new records were set.” See International Tax Blog (May 7, 2015)

**§877A applies to Expatriations occurring after 6-17-2008**

1. Applies a mark-to-market taxation regime on U.S. source income. [Discuss Exceptions]
2. A “covered expatriate” (generally an individual with average annual income of $157,000 for 2014 or net worth of $2 million is deemed to sell all worldwide property for FMV on the day before the expatriation. [Discuss Exceptions]
3. Taxed on gains above $680,000 (indexed for inflation for 2014)
4. New §2801 provides a succession tax on the recipient of a gift from an expatriate at the highest estate tax rate.
Definition: Code §7701(a)(1), (3), and (4).

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

Foreign Corporation: Code §7701(a)(1), (3), and (5).
Partnerships – Conduit Entities

U.S. Partnerships (& LLCs). See §7701(a)(2) and (4)

Foreign Partnership. See §7701(a)(2) and (5).

Partnership status means that entity’s income “flows-through” to the U.S. and the foreign partners to report and pay tax on.

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.

Implication: The existence of entities that can simply “chose” their US tax classification gives taxpayers an opportunity to create hybrid entities (entities that are treated as corporations or disregarded for US tax purposes but the opposite classification for foreign purposes.

Reverse Hybrid Entity: Entity Treated as a Non-Entity for US Tax purposes (it is “open”) but as a “corporation for non-US Tax Purposes.

Reverse Hybrid Entity: Entity Treated as a Corporation for US Tax purposes (it is “closed”) but as a “partnership” or flow-through vehicle for non-US Tax Purposes.
§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?
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.
**Hypothetical:** A Third Foreign Country Corp which is not entitled to US tax treaty protection creates a 100% owned Netherlands subsidiary corporation (“participation exemption”) that in turn owns 100% of U.S. corporation.

**Question:** Does the US-Netherlands Treaty Apply?

**Responses to Treaty Shopping:**
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.
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.
Problem 2: Arlene  
(US Treaty Analysis with Respect to U.S. Source Income)

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?