INTERNATIONAL TAX

Professor William P. Streng

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Chapter One
Introduction

Relevance of this United States international income taxation course

Fundamental income tax considerations concern:

1) *Inbound* (into U.S.) investment and business activities

2) *Outbound* (from U.S.) investment and business activities
United States international taxation

U.S. income taxation of cross-border/transnational transactions; i.e., national, not international law.

Two parallel U.S. income taxation systems:

1) U.S. Internal Revenue Code rules, &
2) a U.S. bilateral income tax treaty
(see the 2016 U.S. Model Income Tax Treaty & the 2014 OECD Model Tax Treaty)

Cf., foreign country income taxation on income derived in country or by its taxpayers.
The process of going outbound from the U.S., p.1

1) Export of tangible goods – often to independent purchasers (or to an intermediary country)
2) Licensing of intangibles (patents, software, know-how, etc.) (whether to the ultimate destination or to an intermediary country)
3) Investment in non-movable assets in the destination jurisdiction (e.g., real estate).
Process of coming into the United States

Immigration – changing individual or entity U.S. tax status

Passive investment in the U.S.
  - securities (stocks & bonds)
  - real estate

Cf., active conduct of a “trade or business” in the United States (i.e., “ETBUS”).
IRC §61 - Income “from whatever source derived”

Basic U.S. tax structure (worldwide income):
1) Tax rates: Individual – 39.6%; Corp. – 35%
2) Capital gain rate preference – for individuals (20%), but not for corporations.
3) Corporate income taxation – classical system of taxation to corporation and its shareholders.
4) Special Code §199 deduction to encourage U.S. based manufacturing.
5) Tax common law concerns: economic substance (§ 7701(o)); business-purpose; substance over form, etc.
How Allocate the Burdens of U.S. Income Taxation?

Taxation of both (1) labor income & (2) capital income.

Tax base theory: p.12
- Cost analysis - cost to the government
- Benefit analysis - what benefits are received by the particular taxpayer?
- Taxpayer’s ability to pay?
What “nexus” for asserting income tax liability?
1. Political allegiance (i.e., passport status); cf., economic allegiance.
2. Residence (for how long?)
3. “Domicile” or permanent residence
4. Physical location (i.e., situs) of the owner’s wealth/property; cf., tangible & intangible property

Are these concepts consistent with “international law”? 

Other jurisdictional approaches: p.13-14
Considering the reach of cross border taxation p.16

What impact of "customary international law" & exercise of extraterritorial taxing jurisdiction?

How mitigate international double taxation? (1) Exemption or (2) tax credit. Cf., tax treaties.

Use a divided taxation approach based on the type of income?

International tax collection & enforcement problems – p.19; no cross-border tax liability enforcement occurs (the "revenue rule"); why?

Therefore, tax collection at source on passive, investment income is necessary.
International Tax Neutrality Concepts  p.20

Capital **export** neutrality - same income tax rate is imposed regardless of the location of U.S. taxpayer’s income (but a possible higher foreign tax cost arises if the foreign tax is higher than the US tax rate; refund of this tax?).

Capital **import** neutrality - all firms in the same market are subject to the same rate of income tax. Only the country where the investment is located imposes an income tax. Implemented through a territorial or exemption approach.

**Should all foreign income be exempted from U.S. income tax for U.S. taxpayers?**
Limiting international economic double taxation

1) territorial/exemption system (exempting foreign income); note current U.S. income tax proposals.

2) (a) foreign tax credit system – the source country has the priority to tax; is source country tax at a higher or lower rate than home country tax? or, (b) a deduction for the foreign tax paid.

3) an agreed allocation of the income tax jurisdiction and liability - e.g., lower withholding rates are imposed at source – a bilateral (rather than a unilateral) response.

1) Taxation of foreign “branch” income - §61 (when the branch has no separate legal identity)
2) Foreign “subsidiary” income – respect the foreign entity as having a separate (foreign) legal status for U.S. income tax purposes. But: possible U.S. income tax applicability of: (1) “Subpart F” (in Subchapter N) for limiting U.S. income tax deferral (i.e., current inclusion required), or (2) PFIC provisions.

Next slide.
How eliminate the U.S. tax deferral opportunity?  p.26


2) Interest charge on the deferred tax amount – PFIC provisions; §1291, et. seq.

3) PFIC - “mark-to-market” of accrued gain – i.e., include unrealized gain in current tax base.

Consider transfer pricing opportunities for shifting income offshore in related party transactions. §482 (p.32).
Does U.S. international tax policy encourage foreign (not U.S.) investment which enables current U.S. based jobs to move offshore?

Is foreign investment (1) a substitute for domestic investment, or (2) an increase in the corporate footprint? I.e., does foreign investment reduce domestic investment?

Consider the “runaway plant” syndrome.
Use U.S. cross-border tax policy to achieve economic or political objectives (rather than merely “raising revenue”)?

Tax penalties/negative tax expenditures.

E.g., (1) anti-boycott provisions re limit of foreign tax credit; (2) no deduction for foreign bribes; (3) no FTC when tax on income is derived in a hostile country.
Potential “Double Non-Taxation”

Cross border tax “arbitrage” –
What is “arbitrage”? “Double benefits”? 
Objective: avoidance of taxation in both jurisdictions (i.e., “double non-taxation”) because of differing residence or sourcing rules.
Achieved through: (1) income characterization rules, & (2) use of “hybrid entities” (e.g., a corporation in one jurisdiction but a flow-through entity in the other jurisdiction).
What Limitations on Cross Border Arbitrage? p.34

Specific limitation statutes; e.g., § 1503(d) re dual consolidated loss rules. Otherwise achieved by different corporate “residency” definitions.

Cf., §7701(o) re “economic substance” doctrine.

Tax shelter limitations & “reportable transactions.” §6111.

FIN 48 – identify potential cost of uncertain tax positions and create reserve for GAAP purposes. Uncertain tax position reporting to be made to IRS on its UTP corporate tax form.
Basics - Foreign Persons  p.36

Active U.S. Business Income

U.S. trade or business income - p.36

Code §§871(b) & 882 – net income tax (39.6/35% rates) imposed on this net income.

Issue concerning what is a “trade or business” in the U.S. – “regular & continuous activities.”

See §864(b). Are personal services included?

What income is "effectively connected" (ECI) with that U.S. trade or business (USTB)? I.e., how strong is the tax inclusion “magnet,” i.e., does a “force of attraction” rule apply?
A §884 “branch profits” tax is applicable on the after-tax profits of the foreign corporation realizing net profits in the U.S.

What is the purpose/timing for this tax imposition?

Is this tax imposed in lieu of a withholding tax on a dividend distribution from a U.S. subsidiary owned by a foreign corporation (or an individual) since no corporate dividend is actually distributed by a branch?
Investment income taxed - §§871(a) & 881(a).

Gross withholding “at source” is applicable.

Exemption from income tax liability available for:

1. portfolio interest;
2. bank interest;
3. capital gains on stock & securities

No U.S. income tax exemption for:

1. real estate income (including sales) (§897), including stock of real estate company (& §1445 withholding); or,
2. contingent royalties (§871(a)(1)(D) & §881(a)(4)) (& §1441 & 1442 withholding).
U.S. Persons - Taxed on Worldwide Income? p.39

1) Taxation on worldwide income. Code §61(a).
   Why worldwide income taxation here?

2) Relief from double taxation – §§901 & 902.
   - direct credit for foreign tax paid; and
   - indirect (or “deemed paid”) credit (for 10% or greater foreign sub. dividends by U.S. corp.).

3) Possible deferral of U.S. income tax (p.40) – subject to: Subpart F regime; PFIC rules.

4) Possible exemption from U.S income tax on certain foreign earned income tax - §911 (p.40).
Individuals - Citizens of the United States

Cook v. Tait, p.41 - issue concerns the U.S. power to tax a foreign resident/U.S. citizen on that person’s foreign sourced rental income:

(1) a U.S. constitutional claim?

(2) an international law claim (violation of principles of customary international law)?

U.S. income tax jurisdiction is based on U.S. citizenship status.
“Resident” Aliens? p.43

“Bright Line” Tests

§7701(b) definitional (objective) provisions for determining resident alien status:

1) “Green card” test, or

2) "Substantial presence" test - current 31 days & 122 day test (3 year) – how computed?

3) “Closer connection” current year exception (p.45) - §7701(b)(3)(B); (a) less than 183 days in U.S., & (b) tax home in the other country. See §162(a)(2) re “tax home” concept.

“Closer connection”, i.e., significant contacts.
Resident Aliens

§7701(b) Exceptions

Excluded days/status for computing “substantial presence” test:

- Commuters (“fast lanes” across borders).
- Crew members of foreign vessel.
- Travelers in transit through the U.S.
- Diplomats & international org. employees
- Certain professional athletes
- Medical condition arising while in U.S. (not if coming to U.S. for medical treatment).
Result of Resident Alien Status? P.46

First year election - §7701(b)(4).

Why? Obtain availability of deductions (e.g., expropriation losses incurred in the former country - deemed occurring as of time of one’s departure from that country).

Cf., deductions for nonresident aliens – only for those expenses attributable to related U.S. business activities.
Problem 2: Substantial presence test? p.47

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 50 days (1/3 of 150 days test)
Year one 23 days (1/6th of 138 days)
193 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) – is the “tax home” in a foreign country? See § 911(d)(3).

§7701(b)(3)(B)(ii) – the "closer connection" test.
Problem 5: Anticipated immigration into U.S. p.48

“Landed basis,” i.e., no “mark-to-market” tax basis regime (therefore, no “landed basis”) when U.S. status commences.

Therefore: i) Sell gain assets before U.S. status (how accomplished?), and,

ii) Retain loss assets (for sale when individual is later subject to U.S. worldwide taxation).

How prove U.S. income tax basis for the prior foreign acquired assets when no “landed basis” system applies?
Furstenberg case: U.S. citizen, married an Austrian prince and lost U.S. citizenship. Was the “principal purpose” of her relocation the loss of U.S. citizenship for tax purposes? Principal purpose: of “first importance.” Held not a tax avoidance purpose. She was a tax neophyte. Cf., Max Kronenberg case – arrival in Switzerland and immediate termination of U.S. citizenship & then business stock sale.
An individual is **conclusively presumed** to have a principal purpose of U.S. tax avoidance for the loss of U.S. citizenship if:

1) **annual average net income tax for five years prior to loss of U.S. citizenship is more than $124,000 (as indexed)**, or

2) **individual's net worth is at least $2,000,000**.

**Tax on U.S. income for ten years after expatriation, i.e. ten year long-arm statute.**

*Exceptions - next slide.*
Exceptions under some circumstances:
1) Citizen of another country at birth & no substantial contacts with the U.S., or
2) U.S. citizen at birth but having foreign parents and less than 30 days in U.S. for each of last ten years & terminate before age 18 1/2.

Similar §877 treatment for “long-term” U.S. residents - i.e., individual spent at least 8 of the prior 15 years in the U.S. How to avoid this rule?

Special income sourcing rules - §877(d)(1) – gains from sale of property as U.S. source.

Special sourcing rule for U.S. stock gains.

Nonrecognition provisions are not applicable when purported tax free exchange occurs for foreign property.

§877(d)(2).

Information reporting requirements apply.

§877(g) – possible worldwide taxation where 30 days+ presence by expatriate in U.S.
Constitutionality of §877?

cf., the challenge in the Di Portanova case, p.52

- invalid exercise of personal jurisdiction

  but, is this source based taxation?

- denial of due process?

  reasonable differentiations permitted?

Real answer? Mark-to-market at time of expatriation; but, consider the “human rights” issue (i.e., denial of “freedom of movement”)?
Expatriations occurring after 6-17-2008. A “mark-to-market” regime replaces the 10-year “alternative tax” on U.S. source income. A “covered expatriate” is deemed to sell all worldwide property for its FMV on the day before expatriation. Taxed on net gains above a $600,000 exemption amount, as indexed ($699,000 for 2017). Uncertain how the tax character is determinedallocated among assets.
Mark-to-Market Rules, continued

“Covered expatriate” – defined by same average annual income tax ($162,000 for 2017) or net worth ($2 million) at date of his expatriation. Exceptions for dual citizens at birth (if not meeting substantial presence test).

Limitation of the “landed basis” rule – solely for purposes of the “exit tax” - basis is value as of the date becoming a resident (& an election out of this rule is possible; e.g., when loss property is held at residence date?). §877A(h)(2).
Covered expatriate can elect to defer payment of tax until (1) actual sale or exchange, (2) failure of adequate security, or (3) death. §877A(b). Must provide “adequate security” & pay interest on the deferred income tax.

Must waive U.S. tax treaty benefits. §877A(b)(5). If death occurs before all deferred tax is paid, then this tax is due on the final U.S. income tax return (&, e.g., no tax basis step-up occurs).
Mark-to-Market Rules, continued; exceptions

Exceptions to the “mark-to-market” rules:

1) Deferred compensation items.
2) Interests in non-grantor trusts, etc.

Is estate tax (not income tax) avoidance the biggest expatriation tax issue? §2107. And, see 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.
U.S. citizenship relinquishment when:
1) Renouncing before a U.S. consular official, or
2) A statement of voluntary relinquishment (and then approved by U.S. State Dept.), or
3) Issuance of “certificate of loss of nationality”
4) U.S. court cancels a naturalized citizen’s certificate of naturalization.

See §6039G re information to be provided to IRS concerning foreign location, etc. What if non-compliance with reporting? P.56
Expatriation Problem - §877 vs. §877A  p.56

Hacker, expatriate, destined for Monaco. Stock gain on his computer company & he wants to avoid U.S. capital gains tax.

Not possible to avoid §877A exposure & no §877A exceptions are available.

Prior advice: live ten years and do not sell stock. Now – an income realization event for U.S. income. Net capital gain of 100 mil. less basis and less exclusion amount (§877A(a)(3)).
Definition: Code §7701(a)(3) & (4) & (5).
“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.
Foreign jurisdictional tests - place of "mind and management" of the corporate entity to establish residency status of a corporation.

Cf., 2005 JCT Options paper test – (noted at p. 57) - use the primary place of management and control?
**Partnerships - conduit entities**  

**U.S. partnerships** (& U.S. LLCs, if a partnership) – **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 needing foreign **corporate** status to avoid conduit, transparent treatment;

includes LLC treated as partnership (for U.S. tax).

Planning for U.S. person: Use a foreign **“blocker”** corp. to hold the foreign partnership interest?
How determine entity characterization?
“Check-the-box” rules, but see listing of certain foreign entities as “per-se” corporations (as categorized for U.S. tax purposes). See Reg. §1.7701-2(b), including 2(b)(8) listing. Other entities are “eligible entities” - which can elect - ordinarily choosing conduit status.
Consider impact of the “default” rule on status.
Election problems with a foreign conduit entity? JCT Options Paper (2005) reconsider “check the box” for foreign entities & 2010 Obama proposal?
How/where created?

§7701(a)(30)(E) - re differentiating 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? Relevance of an ancillary administration?
Issues in these problems:
A) Right of the U.S. to tax under international law?
B) What basis for the exercise of U.S. tax jurisdiction (i.e., by the IRS)?
C) Taxability in the United States?
D) If taxability, then how taxed: (i) gross withholding basis, or (ii) net income basis?
§894(a)(1) – apply “due regard” for treaties.

Purposes of bilateral U.S. income tax treaties:
1) to define “residence” status.
2) provide income tax rate reductions – avoiding double taxation (shift income status to the residence jurisdiction?)
3) cooperation between taxing authorities and to enable the exchange of tax information so as to assure tax compliance in both countries.
Other Relevant Tax International Agreements

1) Tax Information Exchange Agreements (TIEA).
2) FCN Treaties – Friendship, Commerce and Navigation Treaties (not tax, but having wide application).
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 (MLAT) – criminal matters, including tax crimes.
5) Totalization agreement – social security treaty.
1) U.S. Model (2016; cf., 2006 model, but impacted by subsequent bilateral U.S. tax treaties?)

2) OECD Model (2014) – dynamic, i.e., under a regular revision process (see U.S. Technical Explanation notation re OECD Model).

3) U.N. Model – developing countries perspective is included in its provisions.

Possible multilateral income tax treaty? Perhaps on a regional basis? E.g., similar to NAFTA?

Cf., Nordic tax treaty
1) Negotiation by U.S. Treasury Department representatives (& IRS) (not U.S. State Dept.).

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

3) No U.S. House of Representatives (e.g. Ways & Means Committee) participation in the tax treaty process. Therefore, tax treaty can only reduce taxes. Note: Origination clause.

4) Effective upon an exchange of instruments of ratification. Cf., Vienna Convention on Treaties re interpretation of treaties (i.e., Intl. law).
Treatment of Income Items under Income Tax Treaties

Business income - tax if a “P.E.” exists; cf., sales income but no P.E. in a foreign jurisdiction. P.E. status occurs if “dependent” agent exists.

Personal services income - 183 day rule – if income is treated as not received from the U.S. fixed base, i.e., the “commercial traveler” exemption is applied at source.

Nonbusiness income - reduction of the rate of tax & tax withholding at source. Capital gains - tax immunity at source, except for real estate.

Other income - tax at residence.
Certain Treatment under Income Tax Treaties

Taxes covered – p. 67 – “income taxes” (& taxes imposed by sub-national governments in the other country?)

- cf., no treaty limit on state income taxes in U.S.
  Cf., California “unitary taxation.”

Resident status defined (p. 67) – “tie-breaker” rules are applicable.

“Savings clause” applies for U.S. taxpayers, so as to cause worldwide taxation. §1(4). P.68.

Tax expatriation provision is included. §1(4).
1) Third Foreign Country Corp owns 100% of
2) Netherlands Corporation (“participation exemption” treatment) owns 100% of
3) U. S. Corp. (& U.S. investment)

Cf., U.S. outbound investment situation & treaty shopping.

(next slide)
Limit “treaty shopping”? How?
1) “Form vs. substance” – Aiken Industries case. A “mere conduit” situation.
2) Statutory anti-treaty shopping rules – e.g., Code §884(e) (re branch profits tax).
3) General anti-conduit statutory rules – Code §7701(l).
4) “Limitation of benefits” (LOB) provisions in specific income tax treaties: e.g., where corporate shareholders are not actually resident in the U.S. or the treaty country.
Model Treaty, Article 24.
1) Provides for taxation of nationals of the other country on no more burdensome basis than taxation of locals - assuming the same circumstances.
2) Applicability of this tax treaty provision applies to states (i.e., “subnational governments”) in the U.S. (but not for other tax treaty provisions). Art. 24(7).
Problem 1
Wolfgang in the U.S.

Possible income taxation of Wolfgang in the U.S. when also treated as a resident in Germany?
Is relief available under an applicable income tax treaty?
Note: “tie-breaker” rule (Art. 4(3)) in the tax treaty in determining tax status. Article 4(2) may apply concerning the determination of the residence status. Is the “center of his vital interests” in Germany (and, therefore, German residency exists?)
Nonresident with income sourced in the U.S.:
- interest income from a U.S. based loan;
- compensation income from a US. based consulting job (independent contractor).
No office or fixed place of business in the U.S.
See Germany-U.S. Income Tax Treaty:
Art. 11 re interest (& no withholding); and,
Art. 5 and 7 re compensation income, but no P.E. in the U.S.?
1. Information provided to the other country:
   a) Routine exchanges
   b) Spontaneous exchanges
   c) Specific requests
2. Mutual agreement procedures – the “Competent Authority” mechanism.
   What strategies apply in seeking Competent Authority assistance?
3. Privacy concerns – see §6103(k)(4) re IRS sharing information with a tax treaty partner.
4. Binding arbitration to resolve disputes?
Code §7852(d)(1) – provides that neither the tax treaty nor a Code provision has preferential status. Therefore, the “later in time” rule of priority applies – to Code rule or treaty rule. “Treaty override” issue – can/should Congress override a tax treaty? If so, should a delayed effect be included? Is this a violation of international law? See Restatement of Foreign Relations Law of the U.S.