Presentation:

International Income Taxation

Chapter 4: FOREIGN PERSON’S NONBUSINESS US SOURCE INCOME

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Foreign Persons: Nonbusiness U.S. Source Income – Ch. 4

Code §871 (a) & §881(a) – concerning the 30% gross tax on fixed or determinable annual or periodic income (FDAP).

But, FDAP can be “effectively connected” with a U.S. trade or business and then be taxed on a net income basis. §864(c)(2).

Possible modification of the applicable (gross withholding) tax rates by (1) a Code section or (2) a bilateral U.S. income tax treaty.
Why impose tax on a gross basis?

Flat tax on a gross income facilitates collection at source without a taxpayer filing an income tax return.

Limited potential to collect in foreign place.

Gross income and net income are approximately the same amount in many situations involving investment income (i.e., no significant expenses are incurred to generate the investment income).

Is 30% the appropriate tax rate? Cf., corporate tax rate of 35%.
What is “FDAP Income”? 

Interest, dividends, rents and royalties and other fixed or determinable annual or periodic “gains, profits and income”. Code §871(a)(1)(A) & §881(a)(1).

Consider other income sources: annuities, retirement plan distributions, alimony.

Section 871(m) (p.234) was enacted to prevent foreign investors from avoiding U.S. withholding tax on dividends by recharacterizing them through the use of derivative or similar contracts.

Via Treas. Reg. §§ 1.871-7(b)(2), 1.881-2(b)(2), the IRS subjects substitute payments under securities lending arrangements to withholding as interest.
Lump sum amount was received for an exclusive book right in the United States.

Sale of the property interest in a copyright.

Held: one lump sum amount (not contingent) represented the acceleration of all the royalties and, therefore, FDAP.

Do not need multiple payments to have “annual or periodic” payments.
1) Rental income gross-up for expenses or real estate taxes paid by tenant – Rev. Rul. 73-522


3) §871(m) treats “dividend equivalent amounts” as FDAP subject to withholding. A dividend equivalent amount includes payments under a securities lending or repo transaction, payments under an NPC, and other similar arrangements. New 2013 regulations provide complex rules on how much investment return correlation is needed for a contractual return to be considered a dividend equivalent amount.
Rent not paid by a Mexican corporation (HIDRO) ETBUS to related Mexican corporation (Gas) for U.S. use of trucks.

Tax liability results from a Code §482 adjustment. No payments had been made from which the tax could be withheld. Tax obligation of the recipient of the imputed rent exists under §881.

Must an actual payment be made to trigger (1) §881(a) & (2) withholding at source?
1) Bank (and S&L) account interest:
Code §§871(i)(2)(A) & 881(d)

2) Portfolio debt investment interest:
Code §§871(h) & 881(c)

“Bearer” form no longer permitted to qualify for portfolio interest exception. Bond must be in registered form.

Note the carve-out from the portfolio interest exception for bonds held by 10%+ owners or for contingent interest.

What is the impact of these exemption provisions on the U.S. capital markets?

3) However, no exception for 80/20 companies any longer (p.240)
1) Dividends from a U.S. corporation.
Code §861(a)(2)(A) – sourcing

2) U.S. corp. and 80%+ foreign source income: No exception for new companies but a grandfathering for pre-2011 companies if business has not changed.
Code §871(i)(2)(B) – untaxed proportion based on foreign percentage. Cf., interest rule: a sourcing rule

3) Foreign corp. with U.S. source dividends. The branch profits tax rule eliminates the tax liability on dividend.
1) Las Vegas gambling – Code §871(j)

2) Horse & dog racing – Code §872(b)(5)

3) Lottery winnings?

How prove net gambling winnings?

Any offset for invested funds/tax basis?

Any offset for gambling losses? Note §165(d) – losses allowed to extent of gains.

Withholding at source?

Tax treaty reduction – withholding rates:

Dividends: 15%; but, 5% for certain corps.

(Note: recent U.S. treaties – zero withholding tax for payments from subsidiaries)

Interest: -0-

Royalties: -0- (cross-licensing – next slide)

Pensions, annuities and alimony payments: -0-

Annuity defined – see Abeid case, p. 243
Royalty Withholding and Cross Licensing

Rev. Proc. 2007-23 – cross-licensing – two parties grant licenses to each other.

Withholding obligation on gross value? Net?
Rev. Proc. 2007-23 states:

(1) No §1001 gain (or loss) when mutual gains of licenses.

(2) “Net consideration” to be taken into account for (withholding) tax purposes – assuming a “qualified patent cross licensing arrangement” (QPCLA).

(3) Financial statement conformity (i.e., “booking”) requirement.
Historical background: (1) Netherlands Antilles finance sub created by (2) U.S. corp. Purpose: To facilitate borrowing arrangements through Antilles and utilize the U.S. income tax treaty exemption on interest expense paid to the N.A. lender.

This income tax treat functioned as a “treaty with the world”. Why?
Aiken Industries Conduit Arrangement

Transaction Steps:

1) MPI borrows from ECL.

2) ECL sells MPI note to Industrias (in exchange for Industrias notes).

3) MPI pays interest to Industrias. Note: Honduras – U.S. income tax treaty exempts interest from source taxation.

4) Industrias pays interest to ECL

Valid business purpose?
Swiss parent with U.S. operating sub and Netherlands Antilles financing sub (brother-sister subsidiaries).

1. P provides funds to S at 10% interest rate

2. Antilles sub loans funds to U.S. brother-sister at an 11% interest rate, funds sourced from Swiss parent.

Conduit analysis – U.S. to Antilles to Switzerland. Antilles entity was not recognized. Tax under the Swiss treaty?

Is “derivative benefits” concept applicable?
Borrowing by N.A. subsidiary of U.S. parent corporation to exploit the N.A. – U.S. income tax treaty interest exemption.

Tax Court decision: Finance subsidiary is recognized as the borrower. Treated as adequately capitalized.

What debt-equity ratio is necessary to recognize finance subsidiary transaction?

Other suggestions?
1) Treaty Shopping – Article 22.

2) Anti-conduit regulations – Code §7701(1) – conduit entities are disregarded.  p. 231.
   Regs. §1.881-3 & 4. Disregard a conduit?

Does the conduit perform significant financing activities? Is a tax “treaty override” occurring here?  p. 233
Ingersoll-Rand v. Commissioner, T.C. Dkt. No. 025769-13

I-R Company Ltd. (Bermuda)

Global Hldg. (Bermuda)

I-R (Barbados) Hldgs (Barbados)

IRCO Note

$3.6 billion / 11%

I-R Company (Delaware)

IRCO Note

Ontario 3 (Hungary)

I-R (Luxembourg) S.a.r.l. (Luxembourg)

Hungary Note

Lux Note

Loan

Interest

(5% treaty rate wht)

Interest

(0% treaty rate wht)

Interest

(0% treaty rate wht)
NA General Partnership, et al. v. Commissioner, TC Memo 2012-172 (Scottish Power)*

* Note: Tax years predated Section 894(c) proposed regulations targeting this structure
Foreign (forward) hybrid entity:
Corporation in the foreign country but partnership (conduit) status in the U.S.

Reverse hybrid entity:
Corporation for U.S. tax purposes but flow-through entity status for foreign tax purposes.

§894(c) limits treaty benefits and denies deductibility in the NA General Partnership fact pattern (i.e., deductible interest in that fact patterns becomes dividend [to extent of amount of dividend to reverse hybrid] for all tax purposes).

Question: does the US-Netherlands, US-Switzerland or no treaty apply?
Investors own ILL (Swedish corp.)

ILL organized in a jurisdiction (Sweden) where all its shareholders reside.

Article 11 of the income tax treaty exempts the interest payments from tax withholding at source.

No “treaty shopping” here – all ILL owners are Swedish residents (and not U.S. persons).
Problem 2: Substantial Presence Test?

2006 Treaty Art. 22 (2)(e) – 50% rule.

(i) At least 50% is owned by a resident for at least \( \frac{1}{2} \) of the days of the year; and

(ii) Less than 50% of the gross income is paid directly or indirectly to nonresidents of the two treaty countries in a deductible form, i.e., the “base erosion test” is not applicable.
Sale of all stock (when?) to a corp. located in 3rd country (Brazil – no tax treaty).

Treaty benefits are probably jeopardized; but, what if 50 percent of stock of Superrich stock is traded on a U.S. stock exchange or in Sweden? No protection.

Or, an active trade or business in Sweden – Article 22(3).
Treaty article 22(2)(c)(i) & 22(5)(a)).

Treaty benefits are preserved if all ILL shares are trading on the Swedish stock exchange (one of the tax treaty partner countries).

Why preserve tax treaty benefits here?
Problem 5
ILL Shares Traded & Sold

Shares listed and 75 percent of shares sold mostly to non-treaty country residents. Art. 22(2)(c)(i).

Treaty benefits preserved if 75 percent of shares trading on Sweden exchange? Not all shares (of class) must be listed.

Therefore, must Art. 22(2)(e) test be satisfied? Percent owned by Swedish?
75 percent of the ILL shares are sold directly to non-treaty country residents and not publicly listed.

Article 22 will deny treaty benefits to ILL.

Why deny the tax treaty benefit when the shares are not publicly traded?
Problem 7
The “Base Erosion” Test

Loan from bank in Norway to Partsub in Sweden and then loan to parent in U.S.

Partsub being used as a financing subsidiary, although already an operational(?) sub.

Article 22(3) (which preserves a tax treaty benefits in certain trade or business situations) will probably not protect Partsub since no relationship between the lending transaction & trade or business in Sweden.
Problem 8
Base Erosion Test

Loan from bank in Norway to sub in Sweden to parent in U.S.
Amcar (Parent corp.) guarantees the loan to Partsub.

Even if OK under the treaty (Art. 22(3)), note that the guarantee of the loan by Amcar would trigger the application of the anti-conduit rules. See Reg. §1.881-3(c)(2).
Loan from (1) bank in Norway to sub in Sweden (2) to parent in U.S.

Partsub organized **shortly before** the loan agreements were concluded.

Anti-conduit rules would almost certainly apply. Reg. §1.881-3(a)(4) factors appear to be present.

Objective of the intermediary is to reduce U.S. income tax.
Capital gains are not treated as effectively connected with a trade or business.

See U.S. Model Tax Treaty, Article 13(6).

Code §865(a) – source of capital gains from sale or exchange of personal property is at the residence of the taxpayer. Therefore, foreign income for a foreign taxpayer.

Cf., intellectual property transactions. Sale; contingent payments effect – as royalty?
Code §§1441 & 1442 – Withholding at source at 30% rate on FDAP income.

No withholding requirements for ECI – ETBUS income. Code §§1441(c) & 1442(b).

Documentation provided to the payor: IRS Form W-8ECI (formerly IRS Form 4224).
Consider Rev. Rul. 72-87

Concerning corporate E&P calculation. Must payor assume the existence of adequate E&P for dividend characterization. Obsolete by Reg. §1.1441-3(c)(2)(i).

Consider other situations where recovery of tax basis (i.e., basis is not gross income).

What if a nontaxable stock dividend? §305.
Rev. Rul. 80-362 – licensing arrangements re U.S. patent:

A foreign country – license to X
(no income tax treaty with U.S.)

X Netherlands corporation
(Dutch – U.S. treaty) – sublicense

Y U.S. Corporation

Royalties from X to A are not exempt.
Facts:
1. SDI Bermuda licenses to SDI Netherlands
2. SDI Netherlands which licenses to SDI USA.

Why a Dutch intermediary?

Issue: Netherlands to Bermuda royalty payment as U.S. sourced and subject to U.S. gross withholding at source? Held: No.

No conduit argument by IRS.

The SDI Bermuda deal was separate.
Who is the withholding agent?

How does one know whether the payee is domestic or foreign? IRS Form W-9.

Possible exception in ECI & USTB, with representation from recipient.

Use an alternative approach: obtain certification from the home country re tax status as being a resident in other country?

Refund procedure, after status documented?
Normal wage withholding, rather than 30 percent flat rate, for employee.

Rev. Rul. 70-543, p. 248, involving self-employed individuals and horse racing operator. 30% gross withholding at source required for fighter and golfer, but not for horse racing operation (if prior IRS Form 4224 provided, now IRS Form W-8ECI).
Code §1446. The partnership must withhold an amount equal to: (1) the allocable share of partnership income, times (2) the maximum marginal income tax rate.

Any actual distribution is not relevant for this purpose. Note similarity to the branch tax.

The withheld amount will not equal the amount of the net income tax liability.

Consequently, an income tax return is required of the partner.
Proposed Chapter 4, Code §§1471-1474.


To impose a 30% withholding tax at source unless foreign recipient (bank or other) certifies no substantial U.S. owners.

To be a “filter” for Chapter 3 withholding.
Code §897 – gain on U.S. real property sale treated as ECI of USTB.

What is the definition of a “U.S. real property interest” for this purpose?

Real property interests, mines, wells, and “associated personal property”.

Leasehold interests; options to purchase.

What is the reason for this special tax regime pertinent to real property?
Consider:

(1) Loans, but an “equity kicker” loan?

(2) Sale of stock of a “United States real property holding corporation” (all gain subject to tax, not only the U.S. %).

Not including publicly traded stock (except for 5%+ shareholder).
Definition of U.S. Real Property Withholding Corp.

Holds U.S. real property greater than 50% of both (1) real property and (2) trade or business assets of the corporation.

Note: comparative asset values (and currency fluctuations) could cause constant changing of above or below the 50% level.

Why exclude liquid assets from this calculation? An “anti-stuffing rule”??
1) **Sale of Shares** of foreign corporation; but liquidation & redemption distribution?

2) **Distribution by** foreign corporation of its appreciated U.S. real property triggers gain recognition. Code §897(d)(1).

Transferee must withhold 10 percent of the gross amount realized from the disposition transaction. The real “final tax”?

Applies to the *proceeds* (including debt) and **not** to the gain realized from the real estate sales transaction.

U.S. income tax return is required from the seller (to determine net gain/loss).

Cf., possible information reporting.
Exceptions to the withholding requirements – Code §1445(b):

1) Not a foreign seller, e.g., U.S. individual.

2) Corporation not a USRPHCo. How prove this status?

3) IRS “qualifying statement” received.

4) Future use for certain residence purposes.

5) Regularly traded shares (+/- 5%).
Foreign corporate distributions – withhold 35% of the gain amount. Tax applies to the corporation which knows its tax basis for distributed asset. §1445(e)(2).

U.S. corp.? 10% on liquidation distributions.

Partnership & trust distributions –

Withhold 35% of the gain realized to extent allocable to a foreign partner/foreign trust beneficiary. §1445(e)(1).
Is any FIRPTA tax immunity provided under an applicable U.S. bilateral income tax treaty? No.

See U.S. Model Treaty, Article 13, re jurisdiction to tax real estate income – including disposition gain – in the country of situs (including the stock of a USRPHCo.).
Foreign party capitalizes the U.S. subsidiary with both (1) debt and (2) equity.

Dividends subject to possible withholding at source; not deductible by the payor corp.

Interest is deductible (subject to §163(j)) and not subject to outbound withholding (under most bilateral treaties).

What is “debt” as contrasted with “equity”?

See Code §385.
“Earnings-stripping” – re (tax exempt) interest paid to related party - §163(j).

The deduction for “disqualified interest” is postponed.

What is “excess interest expense”?

Debt to equity ratio must exceed 1.5 to 1.

Applicable when a U.S. income tax treaty provides a tax rate reduction on interest, i.e., proportionate reduction.
Earnings Stripping Via Interest Deductions?
High Profile Re-Leveraging Transactions

Foreign Owned MNE Structure

GlaxoSmithKline

- GSK Investment (Switzerland)
- GSK Americas (US)

$13.5 Billion Intercompany Debt
Additional Exposure of $1.06 billion (2004-2008)

Inverted MNE Structure

Tyco

- Tyco Int’l (Switzerland)
- GSK Americas (US)

Interest: $2.8 billion (tax of $883 million)
(add’l $6.6 billion of interest in later years)

IRS Conceded Case Before Trial

Outcome: TBD
This debt includes unrelated party loan interest where a related foreign person guarantees the debt.

Guaranteed debt also includes debt where, e.g., the parent corporation provides a “comfort letter”.

Not relevant when the subsidiary is the guarantor. Why?

NRA has U.S. securities transactions.

Dividends of $30,000 from shares and $200,000 gains and $100,000 losses; total net income of $130,000.


Capital gains not taxable in the U.S.

Dividends subject to U.S. tax in U.S., so $9,000 tax on $30,000 of dividends (30% tax rate, unless 15% rate under a treaty).
Excess Capital Loss

NRA has $200,000 gains and $230,000 losses; net capital loss of $30,000.

Dividend income of $30,000.

Loss of $30,000 is not available to offset the tax on the $30,000 of dividend income (unless ECI & ETBUS). Withholding tax imposed at source on the dividends.
Discretionary authority to buy and sell to be granted to broker.

NRA will not be treated as ETBUS.

Code §864(b)(2) safe harbor provision will continue to apply to the NRA.
Problem 4
§864(b)(2)(B) Safe Harbor

Foreign commodities dealer takes title to wheat in U.S. and the wheat is then sold to the Government of India FOB NYC.

Income from this sale is not FDAP and, arguably, dealer is not ETBUS (since only sporadic U.S. transactions) and, therefore, no U.S. tax liability even though U.S. source income under the title passage test.

No P.E. if an income tax treaty is applicable.

Events are solely in the U.S., but no U.S. tax.
Foreign sales reps send orders to purchasing agents in the U.S. and goods are purchased in the name of foreign corporation.

Orders are accepted in the foreign country.

Title transferred at port of destination.

Customers pay transit insurance.

Not a USTB or P.E.? If so, what income source (U.S. for foreign)?
Foreign corp. sells machinery parts throughout Europe.

Bought parts from a related company in the U.S. and took title to the parts in U.S. and delivered the parts to Europe.

Foreign corp. receives foreign source income from the sale of inventory. U.S. tax? No.

And, no imputed U.S. status because the transaction is between related companies.
Parts are delivered to customers at the U.S. factory and customers pay all shipping costs. Foreign sub receives a 20 percent commission from the U.S.

Empire receives services income and services income is sourced where those services are rendered. Presumably, those services are performed outside the United States.
Problem 8
Royalties or Compensation?

Soprano from France made record in L.A.; similar to the Boulez case?

Receives 10 percent of gross revenue from worldwide sales, described as ‘royalties” under the contract between her and the U.S. recording company.

1) Copyright (royalty) or compensation?

2) Cf., tax treaty treatment: compensation (taxable) or royalty (exempt)? See Art. 17.
Problem 9
Community Income

U.S. citizen moved from U.S. to Peru as employee of sub of U.S. shipping co.

Married Peru citizen/resident.

Peru – community property jurisdiction.

Code §879 says community earnings belong to the working spouse.

Result: All his income (§911 exclusion?)
Employee returns to U.S. without NRA wife and she is an ex-wife.

He transmits alimony (U.S. source) and child support (not income) to Peru.

Also, he pays (U.S. source) interest to Peru bank on his personal loan.

Interest payment subject to 30% U.S. tax withholding at source (tax treaty?).
NRA partner in U.S. partnership with USTB. Equal share in profits and losses.

NRA works in Ireland.

To what extent are services provided in the U.S.? U.S. source income if U.S. based services but not if foreign provided services.

Transform the NRA into an employee?

Include a “special allocation” provision in the partnership agreement?
ETBUS? If not ETBUS, 30% withholding at source on the $100,000(?) annual rental income, plus any real estate taxes paid by the tenant. No deductions for expenses.

Therefore, elect Code §871(d) treatment. Then taxable on Code §1 progressive rates on the net income of each. U.S. Model Treaty – Article 6(5).
NRA sale of U.S. land (i.e., real property).

Yes, §897 imposes tax – FIRPTA rules.

§1445 imposes a withholding obligation at source on the payor.

U.S. Model Income Tax Treaty, Article 13(1), confirms that U.S. jurisdiction exists to tax these real property gains.
NRA invested in wholly owned U.S. corporation:

1) NYC apartment for $2 million

2) Stock (publicly traded): $2 million

3) Art Gallery: $2 million (rented space; annual lease & no renewal right)

Consider (for FIRPTA purposes) the various alternatives concerning the relative fair market values of the several properties.

Issue: Did USRPI > 50% of value in last 5 years?
NRA invested in wholly owned foreign corporation.

The interest in a foreign corporation is not a U.S. real property interest.

Sale of this stock would not be taxed under FIRPTA, but the stock value to be paid should be reduced by the purchaser by the embedded potential internal federal income tax liability.

**Issue:** Did USRPI > 50% of value in last 5 years?
Status of Bluewater as a USRPHCo.?

Yes, became a USRPHCo. when acquiring shares of foreign corp. (Paradise) with U.S. real property (even though U.S. assets had a low tax basis). 40 U.S. and 30 foreign.

See Code §897(c)(5).

The sale of Bluewater shares by Casino (NRA) for 1 million profit results in FIRPTA gain and U.S. tax to Casino.

The “less than 5% rule” is not applicable.
Interest stripping issue: Interest of $280,000 is disqualified interest under Code §163(j)(3)(a) – (1) interest is paid to a related party and (2) no tax applies to interest under the treaty. Debt equity ratio of 2.8:1 exceeds the 1.5:1 limitation.

Excess interest ($30,000) results from $280,000 interest expense over 50% ($250,000) of adjusted taxable income. ($500,000, resulting from gross income: $200,000; depreciation: $20,000; and interest expense: $280,000). §163(j)(1)(A).
Does failure to tax internet profits create an unacceptable advantage for electronic commerce taxpayers over “bricks and mortar” taxpayers?

Note: 2009 commentary on this subject by some CEOs of “bricks and mortar” companies.
Problem 1
Tax Planning

Panco to acquire U.S. real property & stocks and bonds of U.S. real estate companies.

1) Current income – 30 percent tax, unless net election available.

2) Branch profits tax is ETBUS.
3) Listed securities investments – interest and dividends, subject to 30 percent withholding.

4) Sale of real estate – FIRPTA

5) Sale of securities – no tax, unless connected with real estate trade of business.
6) Dividends from Panco producing U.S. taxable income, unless branch profits tax.

7) Use debt leveraging?? But Section 163(j) may be applicable.

8) Cayco –

Where rendering services?

Not subject to FIRPTA.
Problem 2

- How much investment?
- Profit projections?
- Cash flow expectations?
- How deal with U.S. profits?
- Income tax status of the individual?
- Anticipated structure and management?
Problem 3

Nontax considerations, e.g., limitation of liability.

What alternative structures for tax planning?

Debt financing?

Resident alien status of individual?

Branch profits tax & FIRPTA applicable?
Investment environment in U.S. – Are tax burdens on foreign investment more favorable than for domestic based investment?

Cf., force of attraction rule vs. P.E. test (with only P.E. income being taxed).

Consider focus of U.S. income tax treaties.