Chapter One

Introduction

Relevance of this U.S. International Taxation course

Considerations concern:
1) *Inbound* investment and business activities
2) *Outbound* investment and business activities

United States international taxation

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

Two U.S. income taxation systems:
1) Internal Revenue Code rules, &
2) a U.S. bilateral income tax treaty
(see the 1996 U.S. Model Income Tax Treaty & the 2010 OECD Model Tax Treaty)

Cf., foreign country income taxation.
The process of going outbound from the U.S., p.1

1) Export of tangible goods

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

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

Process of coming into the United States p.2

Immigration – changing individual or entity U.S. tax status
Passive investment in the U.S.
- securities (stocks & bonds)
- real estate
Active conduct of a trade or business in the U.S.

IRC §61 - Income “from whatever source derived”

Basic U.S. tax structure (worldwide income):
1) Tax rates: Individual – 35%;
   Corporate – 35% (through 2012)
2) Capital gain rate preference – for individuals, but not for corporations.
3) Corporate taxation – classical system of taxation to corporation and shareholder.
4) Special § 199 deduction to encourage U.S. manufacturing.
5) Tax Common law: 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 received by the taxpayer?
- Ability to pay?

Other jurisdictional approaches: p.13

What “nexus” for asserting income tax liability?
1. Political allegiance (i.e., passport); 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

These concepts consistent with “international law”?

Considering the reach of cross border taxation p.14

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 regardless of the location of taxpayer's income (but a possible higher foreign tax cost if foreign tax is higher than the US tax rate; refund 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 income tax. Implemented through a territorial or exemption approach. Exempt foreign income from U.S. income tax?

Limiting international economic double taxation

1) territorial/exemption system; note current tax proposals
2) (a) foreign tax credit system – the source country has the priority to tax; higher or lower rate than the 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 at source – a bilateral (rather than unilateral) response.


1) Taxation of foreign “branch” income - §61
2) Foreign “subsidiary” - respecting the foreign entity as having separate legal status for U.S. tax purposes.
   But, possible U.S. income tax applicability of “Subpart F” (Subchapter N) for limiting U.S. income tax deferral (i.e., current inclusion). Eliminate deferral opportunity?
   Consider transfer pricing opportunities (p.32)
How eliminate deferral opportunity? p.26

1) Current recognition – Subpart F provisions
2) Interest charge on the deferred tax amount – PFIC provisions; §1291, et. seq.
3) “Mark-to-market” – including unrealized gain in tax base.

Consider transfer pricing opportunities for shifting income offshore. §482 (p.32).

Domestic Effects of Foreign Investment p.26

Doest U.S. international tax policy encourage foreign (not U.S.) investment which enables jobs to move offshore?

Is foreign investment a substitute or an increase in the corporate footprint?

I.e., does foreign investment reduce domestic investment?

Consider the “runaway plant” syndrome.

Potential “Double Non-Taxation” p.33

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., corporation in one jurisdiction but flow-through entity in other jurisdiction).
Limitations on Cross Border Arbitrage  p.34

Specific statutes; e.g., § 1503(d) re dual consolidated loss rules. Otherwise achieved by different corporate “residency” definitions.
Tax shelter limitations & “reportable transactions.”
FIN 48 – identify potential cost of uncertain tax positions and create reserve for GAAP purposes.
Uncertain tax position reporting to IRS on its UTP corporate tax form.

Basics - Foreign Persons  p.36
Active Business Income  

U.S. trade or business income - p.36
  Code §§871(b) & 882 – net income tax (35% rate).
Issue concerning what is a “trade or business” in the U.S. See §864(b). Personal services?
What income is “effectively connected” (ECI) with that U.S. trade or business (USTB)?

Tax on U.S. Profits of Foreign Corporation  p.37

A §884 “branch profits” tax is applicable on after-tax profits of foreign corporation realizing net profits in the U.S.
What is the timing for this tax imposition?
In lieu of withholding tax on a dividend distribution from a U.S. subsidiary held by a foreign corporation (or an individual).
**U.S. Investment Income of Foreign Persons**

Investment income taxed - §§871(a) & 881(a).
Gross withholding “at source” is applicable.
Exemption from income tax liability 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?**

1) Taxation on worldwide income. Code §61(a).
2) Relief from double taxation –
   - direct credit
   - indirect (or “deemed paid”) credit (for 10% or greater subsidiary owned 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 foreign earned income tax - §911 (p.40).

**U.S. Citizens Worldwide Taxation**

Individuals - Citizens of the U.S.

*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 income:
(1) a U.S. constitutional claim?
(2) an international law claim?
U.S. income tax jurisdiction is based on U.S. citizenship status.
**Resident Aliens**

**"Bright Line" Tests**

§7701(b) definitional provisions:
(1) “Green card” test, or
(2) "Substantial presence" test
   122 day test - how computed?
(3) "Closer connection" exception (p.45) - §7701(b)(3)(B); (a) less than 183 days in U.S. & (b) tax home in the other country. §162(a)(2) re “tax home” concept.

**Resident Aliens**

**§7701(b) Exceptions**

Commuters
Travelers in transit
Diplomats & international organization employees
Certain professional athletes
Medical condition arising while in U.S.

**Result of Resident Alien Status?**

First year election - §7701(b)(4).
Availability of deductions (e.g., expropriation losses in former 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 test)
Year one 23 days (1/6th of 138 days) 193

continued

Wolfgang, cont. re: U.S. taxpayer status

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.

Problem 5: Anticipated immigration into U.S. p.48

“Landed basis,” i.e., not a “mark-to-market” tax basis regime when U.S. status commences. 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 when no “landed basis”? 
Former U.S. Citizens and Residents - prior cases

Was “principal purpose” of her relocation 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 citizenship.

Tax expatriate provision - Code §877

Individual 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 $147,000 (as indexed for 2011, Rev. Proc. 2010-40), or
2) individual's net worth on that date is at least $2,000,000.

Code §877, continued

Exceptions

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 foreign parents and less than 30 days in U.S. for each of last ten years.
Similar treatment for “long-term” U.S. residents - i.e., individual spent at least 8 of the prior 15 years in the U.S.
**U.S. Income Treatment of U.S. Tax Expatriates?**

Special income sourcing rules - §877(d)(1) – gains from sale of property as being U.S. source income.
Special sourcing rule for U.S. stock gains. Nonrecognition provisions not applicable. Information reporting requirements. §7701(n) for determining change in status. §877(g) – possible worldwide taxation where more than 30 days in U.S.

---

**Code §877, continued**

Constitutionality of §877?
- cf., 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, “human rights” issue?

---

**Mark-to-Market Rules Section 877A**

“Covered expatriate” deemed to sell all worldwide property for FMV on the day before his expatriation. Taxed on gains above $600,000+. Uncertain how the tax character is determined/allocated among assets.
Mark-to-Market Rules, continued

“Covered expatriate” – defined by same average annual income ($147,000 for 2011) 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 date becoming a resident (& an election out of this rule is possible; when loss property held at residence date?). §877A(h)(2).

Mark-to-Market Rules, continued

Covered expatriate can elect to defer payment of the tax under an actual sale or exchange, failure of security or death. §877A(b).
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.

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 avoidance the biggest expatriation tax issue?
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.
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 §877 exposure & no §877 exceptions are available.
Advice: live ten years and do not sell stock – have income realization event for U.S. income tax purposes after the 10 year period expires.
But, is §877A presently applicable? Result?

U.S. Corporations p.56
Identifying U.S. Tax Status

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 primary place of management and control.

Partnerships - conduit entities p.57

U.S. partnerships (& U.S. LLCs, if 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 an LLC treated as a partnership (for U.S. tax purposes).
Planning: U.S. person - Use a foreign “blocker” corp. to hold foreign partnership interest?
The Entity Characterization Process

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). See Reg. §1.7701-2(b), including 2(b)(8) listing.
Other entities are “eligible entities” - which can elect - ordinarily for 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. & Obama proposal?

Trusts & Estates

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?

Problem - U.S. Cleanliness and Camclean Foreign Sub.

Issues in these problems:
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 taxed: on (i) a gross withholding basis or (ii) a net income basis?
The Role of International Bilateral Tax Treaties p.62

§894(a)(1) - “due regard” for treaties.

Purposes of bilateral income tax treaties:
1) to define “residence” status.
2) provide tax rate reductions – avoiding double taxation (allocate income to residence?)
3) cooperation between taxing authorities and to 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) Totalization agreement – social security treaty

Model Bilateral Income Tax Treaties p.63

1) U.S. Model (2006, as modified by subsequent bilateral U.S. treaties?)
2) OECD Model (2010) – dynamic, i.e., under a regular revision process (see U.S. Tech. Explanation notation).
3) U.N. Model – developing countries perspective is included
Possible multilateral income tax treaty?
Tax Treaty Making & Ratification Process p.64

1) Negotiation by U.S. Treasury Department representatives (& IRS).
2) “Advice & consent” by U.S. Senate, after review by Senate Foreign Relations Committee (not the Senate Finance Committee).
3) No U.S. House of Representatives (e.g. Ways & Means Committee) participation in the tax treaty process.
4) Effective upon an exchange of instruments of ratification. Cf., Vienna Convention on Treaties.

Treatment of Income Items under Income Tax 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 is not received from a U.S. fixed base.
“Commercial traveler” is exempt from tax at source.
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.

Certain Treatment under Income Tax Treaties

Taxes covered – p. 67 – “income taxes” (& in other country?)
- not state taxes. Cf., California “unitary taxation.”
Resident status defined (p. 67) – “tie-breaker” rules are applicable.
“Savings clause” for U.S. taxpayers. §1(4).
Tax expatriation provision is included.
Treaty Shopping - Inbound Situation & “LOB”  p.68

1) Third Foreign Country Corp owns 100% of
2) Netherlands Corporation (“participation exemption”) owns 100 % of
3) U. S. Corp. (&U.S. investment)

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

(next slide)

Responses to “Treaty Shopping”  p.69

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(l).
4) “Limitation of benefits” provisions in specific income tax treaties.

Treaty Nondiscrimination Provision  p.69

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 this tax treaty provision to states in the U.S. (but not other tax treaty provisions). Art. 24(7).
Problem 1

Wolfgang in the U.S.

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 the residence status.

Problem 2

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.
See Germany-U.S. Income Tax Treaty provisions: Art. 11(1) re interest; and, Art. 5 and 7 re compensation income.

Tax Treaty Administrative Cooperation Provision

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 in seeking Competent Authority assistance?
3. Privacy concerns – see §6103(k)(4) re IRS sharing information with treaty partner
4. Binding arbitration to resolve disputes?
Relationship between the Tax Treaty and the Code

Code §7852(d)(1) – provides that neither the tax treaty nor a Code provision has preferential status.

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

“Treaty override” issue – can/should Congress override a tax treaty? If so, include a delayed effect? A violation of international law?